1 UNITED STATES OF AMERICA,
District of Connecticut, ss:

I, Charles E. Pickett, clerk of the District Court of the United States of America for the District of Connecticut, Second Circuit, by virtue of the following writ of error, and in obedience thereto, do hereby certify that the pages number from 1 to 53, inclusive, contain a true and complete transcript of the record and proceedings had in said court in the cause of James J. Walsh, collector of internal revenue, plaintiff in error, against Frederick F. Brewster, defendant in error, as the same remain of record and on file in said office.

In testimony whereof I have caused the seal of the said court to be hereunto affixed, at the city of New Haven, in the District of Connecticut, in the Second Circuit, this 7th day of February, in the year of our Lord one thousand nine hundred and twenty-one, and of the Independence of the United States the one hundred and forty-fifth.

[SEAL.]

C. E. PICKETT,
Clerk.

2 WRIT OF ERROR.

UNITED STATES OF AMERICA, *ss:*

The President of the United States of America to the judge of the District Court of the United States for the District of Connecticut, greeting:

Because, in the record and proceedings, as also in the rendition of the judgment of a plea which is in the District Court, before you, between James J. Walsh, collector of internal revenue, plaintiff in error, against Frederick F. Brewster, defendant in error, a manifest error hath happened, to the great damage of the said James J. Walsh, collector of internal revenue, plaintiff in error, as is said and appears by his complaint, we, being willing that such error, if any hath been, should be duly corrected, and full and speedy justice done to the parties aforesaid in this behalf, do command you, if judgment be therein given, that then under your seal, distinctly and openly, you send the record and proceedings aforesaid, with all things concerning the same, to the Supreme Court of the United States, at the city of Washington, together with this writ, so that you have the same at the said place, before the Supreme Court of the United States aforesaid, within thirty days from the date hereof, that the record and proceedings aforesaid being inspected, the said Supreme Court of the United States may cause further to be done therein, to correct that error, what of right and according to the law and custom of the United States ought to be done.

Witness, the Honorable Edward D. White, Chief Justice of
3 United States, this 4th day of February, in the year of our Lord one thousand nine hundred and twenty-one, and of the Independence of the United States the one hundred and forty-fifth.

C. E. PICKETT,
Clerk of the District Court of the United States of America for the District of Connecticut, in the Second Circuit.

The foregoing writ is hereby allowed.

EDWIN S. THOMAS,
United States District Judge.

4 In the United States District Court for the District of Connecticut.

FREDERICK F. BREWSTER, PLAINTIFF,
vs.
JAMES J. WALSH, COLLECTOR OF internal revenue, defendant.

PETITION FOR WRIT OF ERROR.

To the Supreme Court of the United States of America:

The above-named James J. Walsh, collector of internal revenue, now appears before this court and complains that in the records and proceedings had in this cause, and also in the rendition of the judgment in the above-entitled cause, in the District Court of the United States for the District of Connecticut, on the 16th day of December, 1920, manifest error hath happened to the great damage of said defendant, all of which will more in detail appear from the assignment of errors which is filed with this petition.

Wherefore, the said defendant hereby prays that a writ of error may issue in his behalf from the Supreme Court of the United States to the United States District Court for the District of Connecticut for the correction of the errors and the reversal of the final order and judgment so complained of; that a transcript of the record, proceedings, and papers in this cause, duly authenticated, may be sent to the said Supreme Court of the United States; that said writ of error operate as a supersedeas; and that such other order and process issue as may cause the aforesaid errors and judgment to be corrected by the said Supreme Court of the United States.

Dated, Hartford, Connecticut, in the District of Connecticut, the 4th day of February, 1921.

ALLAN K. SMITH,
Assistant U. S. Attorney,
Attorney for the Defendant.

5 At a stated Term of the District Court of the United States, held in and for the District of Connecticut, at the courthouse, in the United States Post Office and Courthouse Building, in the city of New Haven, on the 4th day of February, 1921.

Present: Hon. Edwin S. Thomas, U. S. District Judge.

FREDERICK F. BREWSTER, PLAINTIFF,
against
JAMES J. WALSH, COLLECTOR OF INTERNAL REVENUE, DEFENDANT.

ORDER ALLOWING WRIT OF ERROR.

The above-named defendant, James J. Walsh, collector of internal revenue, having filed a petition for a writ of error and an assignment of errors in the above-entitled action, it is now

Ordered, that a writ of error be, and the same hereby is, allowed to have reviewed in the Supreme Court of the United States the record and proceedings and the judgment heretofore on the 16th day of December, 1920, rendered in this court in this cause.

EDWIN S. THOMAS,
U. S. District Judge.

6 United States District Court for the District of Connecticut.

FREDERICK F. BREWSTER, PLAINTIFF,
against
JAMES J. WALSH, COLLECTOR OF INTERNAL REVENUE, DEFENDANT.
Law. No. 2133.

UNITED STATES OF AMERICA,
District of Connecticut, ss:

The President of the United States of America to the marshal of the District of Connecticut, greeting:

You are hereby commanded to summon James J. Walsh, collector of internal revenue for the District of Connecticut, the defendant herein, to appear before the District Court of the United States for the District of Connecticut on the first Monday in March, 1919, then and there to answer unto Frederick F. Brewster, of the town of Hamden, in the State of Connecticut, the plaintiff herein, in a civil action wherein the plaintiff complains and says:

1. The plaintiff at all of the times hereinafter mentioned was and still is a citizen of the State of Connecticut and a resident of the internal revenue district of Connecticut.

2. At all of the times hereinafter mentioned the defendant was and still is collector of internal revenue of the United States for the District of Connecticut.

7 3. The plaintiff is not and was not at any of the times herein mentioned a member of any stock exchange or other similar organization or association for the purpose of trading in or buying or selling securities, nor was he a trader or dealer in stocks or bonds or engaged in the business of buying or selling stocks or bonds otherwise than as an investor, and as such occasionally purchasing stocks

and bonds for investment and occasionally buying and selling for the purpose of changing investments.

4. On or about April 19, 1899, plaintiff became the owner of $191,000 face value of certain interest-bearing bonds of International Navigation Company, a domestic corporation, the said bonds being described as first mortgage sinking fund bonds, which plaintiff acquired in exchange for certain notes and bonds of the said corporation, which were of the value of $191,000, and plaintiff continued to own said bonds until 1916, when he sold the same as hereinafter set forth.

5. On March 1st, 1913, first mortgage sinking fund bonds of International Navigation Company were depressed in the market and the market quotation therefor upon said day was 79½ asked and no bids, meaning that certain of said bonds were offered for sale in the market at 79½% of their face value.

6. During the calendar year 1916 the plaintiff sold said International Navigation Company first mortgage sinking fund bonds for the face value thereof, to wit, $191,000.

7. On or about March 6th, 1906, plaintiff became the owner of $257,000 face value of certain bonds of International Mercan-
8 tile Marine Company, a domestic corporation, such bonds being described as first mortgage bonds of said corporation, at a cost to the plaintiff as nearly as the same can be estimated of 106.2% of the face value thereof, to wit, $272,934, and the plaintiff continued to own said first mortgage bonds of International Mercantile Marine Company until 1916, when he sold the same as hereinafter set forth.

8. On March 1st, 1913, the first mortgage bonds of International Mercantile Marine Company were depressed in the market and the market quotation on said date was 64 bid and 64½ asked, meaning that certain of said bonds were offered for sale at 64½% of their face value and that an offer or offers were made to purchase the same at 64% of their face value.

9. During the calendar year 1916 the plaintiff sold $100,000 face value of said first mortgage bonds of said International Mercantile Marine Company at 107¾% of their face value and received therefor $107,375, and the plaintiff during said year likewise sold $157,000 face value of said bonds at 107¼% of their face value, and received therefor $168,775, in both cases for the sole purpose of and incident to making a change of investments.

10. On January 1st, 1916, the Standard Oil Company of California was, and had been for many years, and still is, a corporation organized and existing under and by virtue of the laws of the State of California, and on said date had an authorized capital stock of $100,000,000 divided into 1,000,000 shares of the nominal or par value of
9 $100 each and said corporation then had issued and outstanding stock of the nominal or par value of $49,686,656. On said date the said corporation had surplus assets and undivided profits invested in plant and property and used in the busi-

ness of and required for the purposes of the said corporation amounting to the sum of $44,852,263.02, of which $20,353,968.34 had been earned by said corporation prior to March 1st, 1913, and the balance of said surplus and undivided profits had been earned by said corporation subsequent to that date.

11. The board of directors of said Standard Oil Company of California at a meeting held on the 16th day of January, 1916, for the purpose of readjusting the capitalization of said corporation, determined to issue additional shares of stock constituting a stock dividend of 50% upon its outstanding capital stock from the authorized capital stock of said company, and to transfer from surplus account to capital stock account an amount equivalent to said stock dividend. The said board of directors duly adopted a resolution declaring said dividend as follows:

"Whereas the issued capital stock of this corporation consists of $496,866\frac{545,614}{983,383}$ shares of a par value of one hundred dollars ($100) each; and

Whereas the unissued capital stock of this corporation consists of $503,133\frac{437,769}{983,383}$ shares;

Whereas the net assets of this corporation exceeded the par value of the issued capital stock by far more than twenty-five million dollars ($25,000,000) and the surplus of this corporation is greatly in excess of twenty-five million dollars ($25,000,000); and

Whereas said surplus was derived from earnings of the corporation and profits of the business;

Now, therefore, be it

Resolved, That subject to the approval of the said authorities, a stock dividend of $248,433\frac{272,807}{983,383}$ shares of the capital stock of this corporation, of the par value of one hundred dollars ($100) each be, and the same is hereby, declared payable on April 15, 1916, or as soon thereafter as delivery can be made, to the stockholders of this corporation of record on its books at close of business March 4, 1916, in the proportion of one-half of a share for each share of stock then so owned and held by each of said stockholders as shown by said books.

Resolved further, That the president and secretary of this corporation are hereby authorized and empowered to take whatever steps they may deem necessary to carry this resolution into effect, and to notify the stockholders of the purport thereof."

12. Thereafter in accordance with said resolution the officers of said Standard Oil Company of California transferred from surplus account to capital stock account the sum of $24,843,327.74, being the equivalent of said stock dividend, and on or about the 15th day of April, 1916, issued to the stockholders of record of the said corporation on the 4th day of March, 1916, additional shares of stock in the

proportion of one share of new stock for each two shares of old stock held by each shareholder on said date.

13. On March 4th, 1916, the plaintiff was the owner of 1,330 shares of stock of the Standard Oil Company of California, and on
11 or about the 15th day of April, 1916, in accordance with the aforesaid action of said corporation, the plaintiff received from the Standard Oil Company of California certificates representing additional shares of stock amounting to 665 shares. Because of the issue of said additional shares constituting said stock dividend the actual value of each share of stock, the value of which was based solely upon the total assets of the company was decreased, and the proportional decrease in actual value was reflected by a decrease at the same time in the market value of each share. During the month prior to the declaration of said stock dividend and immediately thereafter, sales of the said stock had been made in the market at prices from $360 per share to $382 per share, whereas during the period after the issue of said stock dividend the price of said stock ranged from $234 per share to $268 per share. The actual value of the stock owned by each stockholder, including the plaintiff, was unchanged by reason of the declaration of said stock dividend and the issue of said additional shares of stock, the proportionate interest in the assets and business of said corporation being identically the same when represented by two shares of stock prior to the stock dividend and when represented by three shares of stock subsequent thereto.

14. By resolution of the board of directors of the Standard Oil Company of California the said sum of $24,843,327.74 equal to the par value of the shares of stock constituting the said stock dividend and charged from surplus account to capital account was to the amount of $20,353,068.34 charged against surplus and undivided profits of said corporation earned prior to March 1st, 1913, and the balance thereof, amounting to $4,490,259.40, was charged
12 against the first surplus profits of said corporation earned after March 1st, 1913, the result being that 18.0743% of said $24,843,327.74 was charged against surplus and undivided profits earned since March 1st, 1913.

15. In accordance with the provisions of the income tax law, being title 1 of an act of Congress in effect September 9, 1916, entitled "An act to increase the revenue and for other purposes," the plaintiff in the year 1917 duly filed his return of income received during the year 1916, and paid the tax assessed by the defendant as collector of internal revenue for the district of Connecticut thereon. In determining the amount of taxable income received by the plaintiff during the year 1916 and in ascertaining and fixing the income tax due thereon the sums received by the plaintiff from the sale of the aforesaid $191,000.00 face value of first mortgage sinking fund bonds of the International Navigation Company, the sums received from the sale of said $257,000 face value of first mortgage bonds of

International Mercantile Marine Company, and the said 665 shares of stock of the Standard Oil Company of California were excluded, but the plaintiff attached to his said return and filed therewith with said collector, a statement describing the said transactions and asserting that no taxable income was derived therefrom.

16. Thereafter the defendant, as collector of internal revenue for the district of Connecticut, claiming to act in pursuance of the provisions of the said income tax law demanded of the plaintiff the sum of $17,689.13, which the defendant claimed to be due and payable, after giving credit to the plaintiff for an excess payment of normal income tax of $67.66, as an income tax on $150,825,
13 alleged to be profit upon the sale of said International Navigation Company and said International Mercantile Marine Company bonds, and $12,919.41 on said 665 shares of stock of the Standard Oil Company of California received by the plaintiff as aforesaid in the year 1916, and which said sum of $150,825 and 18.0743% of the par value of said stock the defendant claimed to constitute taxable income; and the defendant threatened to enforce the payment of said tax, together with the penalties and interest as provided in the act, by distraint and sale of property. And thereupon the plaintiff solely to avoid the imposition of penalties and interest, and under compulsion, duress and coercion, paid to the defendant as such collector, on or about the 19th day of July, 1918, the sum of $17,689.13, but under protest, and at the same time protested in writing that no tax was due from the plaintiff, but that on the contrary the United States was indebted to the plaintiff in the sum of $67.66, constituting an over-payment of the normal tax due upon plaintiff's income for the year ending December 31, 1916, and that the plaintiff paid the same under duress and compulsion.

17. Thereafter the plaintiff duly took an appeal to the Commissioner of Internal Revenue and demanded repayment of said tax, in accordance with law and the regulations and rules of the Treasury Department. Said appeal was duly perfected and filed with the Commissioner of Internal Revenue on or about the 14th day of September, 1918, and thereafter on or about the 21st day of January, 1919, said Commissioner of Internal Revenue refused to grant said appeal and rejected plaintiff's claim for a refund of said sum of $17,689.13 paid as aforesaid, or any part thereof.

14 18. The difference between the market price of the aforesaid first mortgage sinking fund bonds of International Navigation Company and said first mortgage bonds of the International Mercantile Marine Company, and the amounts received therefor by plaintiff upon the sale thereof, and the additional shares constituting the aforesaid stock dividend of the Standard Oil Company of California, notwithstanding the fact that 18.0743% thereof was charged against earnings and profits accrued since March 1st, 1913, did not constitute taxable income under the income tax law. No tax was due or has become due thereon to the United States Government or to the defendant as collector of internal revenue for the

district of Connecticut, and the amount of tax paid thereon, viz, $17,689.13, together with the retention of the sum of $67.66 over-payment of normal tax as aforesaid, was illegally and without warrant or authority or within the law, demanded and collected by the defendant from the plaintiff.

19. The act of Congress under which the aforesaid sum of $17,689.13, together with the aforesaid retention of $67.66 over-payment of normal tax was levied as aforesaid and its payment compelled, to wit, title 1 of an act of Congress, entitled "An act to increase the revenue, and for other purposes," is invalid and void in so far as the same may be asserted to empower the aforesaid levy of income tax on the proceeds of the sales of the aforesaid bonds of the International Navigation Company and the International Mercantile Marine Company, and on said additional shares constituting the said stock dividend issued by said Standard Oil Company of California,
15 or to compel such payment as aforesaid because in so far as it be asserted to accomplish such purposes it is in violation of the provisions of article 1, section 2, clause 3 of the Constitution of the United States, which provides that "direct taxes shall be apportioned among the several States," and of the provisions of article 1, section 9, clause 4 thereof to the effect that "No capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken." The said difference between the market price of the said bonds on March 1st, 1913, and the amount received by the sale thereof, and said additional shares issued to the plaintiff as aforesaid and constituting said stock dividend, did not in whole or in any part or proportion thereof constitute income and was not subject to taxation as income within the meaning of the provisions of the XVIth amendment of said Constitution to the effect that "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration"; and the plaintiff draws in question the constitutionality of the said act of Congress and of all provisions thereof assumed or asserted to authorize the said levy and the enforcement thereof.

20. No part of said sum of $17,689.13 or said sum of $67.66, retained as aforesaid, has been repaid to the plaintiff, and the whole amount thereof with interest thereon from the 19th day of July, 1918, remains due and owing from this defendant to this plaintiff.

21. This is a suit of a civil nature at common law, and the matter in controversy exceeds, exclusive of interest and costs, the sum
16 of $3,000, and this suit and the cause of action herein set forth arise under the Constitution and laws of the United States providing for internal revenue.

Wherefore, the plaintiff claims and demands judgment against the defendant for the sum of $17,756.79 with interest thereon from the 19th day of July, 1918, together with the costs and disbursements of this action.

Henry F. Parmelee, of New Haven, is recognized in the sum of $150.00 to prosecute, etc.

Hereof fail not, but of this writ due service and return make.

Witness the Honorable Edwin S. Thomas, judge of the District Court of the United States, for the District of Connecticut, and the seal of said court, at Hartford, in said district, this 10th day of February, A. D. 1919.

C. E. PICKETT,
Clerk of the District Court of the United States, for the District of Connecticut.
HENRY F. PARMELEE,
Attorney for Plaintiff, Office and Post Office Address, #865 Chapel Street, New Haven, Conn.
GEORGE D. WATROUS,
HENRY F. PARMELEE,
Of Counsel.

HARTFORD, CONN.,
February 10, 1919.

UNITED STATES OF AMERICA,
District of Connecticut:

By virtue hereof I made due service by leaving a true and attested copy of this writ in the hands of James J. Walsh, collector of internal revenue.

Attest:

C. C. MIDDLEBROOKS,
U. S. Marshal.
By T. E. HAWLEY,
Deputy U. S. Marshal.

Fees:

1 mile	.06
1 service	2.00
	2.06

Expenses: Trolley, Hartford, .12.

17 United States District Court for the District of Connecticut.

FREDERICK F. BREWSTER, PLAINTIFF,
vs.
JAMES J. WALSH, COLLECTOR OF INTERNAL REVENUE, DEFENDANT.
No. 2133.

ANSWER.

1. Paragraphs 1, 2, 3, 6, 9, 10, 11, 12, 14, 15, 17, and 21 of plaintiff's complaint are admitted.

2. Paragraphs 18 and 19 are denied.

3. The defendant admits the allegations of paragraph 4, excepting so much thereof as alleges that the plaintiff exchanged for said bonds

certain notes and bonds of the value of $191,000.00, as to which allegation the defendant has not sufficient knowledge or information to form a belief and leaves the plaintiff to his proof thereof.

4. The defendant denies the truth of the matters contained in paragraph 5 excepting so much thereof as alleges that the market quotation for the first mortgage sinking fund bonds of International Navigation Company on March 1st, 1913, was 79½ per cent asked and no bids, meaning that certain of said bonds were offered for sale in the market at 79½ per cent of their face value and the defendant alleges that the annual range of prices for said bonds during the years 1912, 1913, and 1914, stated in percentage of their face value, was as follows:

18

1912.

High---------- 82½ (April). Low---------- 77¾ (October).

1913.

High---------- 79¾ (January). Low---------- 75 (November).

1914.

High ---------- 77½. Low---------- 71⅝.

It thus appears that the price on March 1st, 1913, was not depressed but was near the highest price for that year, and higher than the price during part of the year 1912 and all the year 1914.

5. The defendant admits the allegations of paragraph 7, excepting so much thereof as alleges the consideration paid for said bonds of International Mercantile Marine Company as to which allegation the defendant has not sufficient knowledge or information to form a belief and leaves the plaintiff to his proof thereof.

6. The defendant denies the truth of the matters contained in paragraph 8 of the plaintiff's complaint excepting so much thereof as alleges that on March 1st, 1913, the market quotation of the first mortgage bonds of the International Mercantile Marine Company was 64 bid and 64½ asked, meaning that certain of said bonds were offered for sale at 64½ per cent of their face value and that an offer or offers were made to purchase the same at 64 per cent of their face value, and the defendant alleges that the annual range of prices of said bonds during the years 1912, 1913, 1914, and 1915 stated in percentage of their face value, was as follows:

1912.

High ---------- 70⅝ (March). Low---------- 63 (April).

1913.

High---------- 66⅛ (January). Low---------- 56½ (June).

1914.

High---------- 61 (January). Low ---------- 29¾ (December).

19 1915.

High---------- 97½ (December). Low ---------- 30¼ (January).

It thus appears that the price on March 1st, 1913, was not depressed but was near the highest price for that year, and higher than the price during part of the year 1912, and all the year 1914.

7. The defendant alleges that on March 1, 1913, and for a long time prior thereto, the plaintiff had been the owner of 1,330 shares of the capital stock of the Standard Oil Company of California. The defendant denies the truth of the matters contained in paragraph 13 of the plaintiff's complaint excepting so much thereof as alleges that on March 4th, 1916, the plaintiff was the owner of 1,330 shares of stock of the Standard Oil Company of California and on or about April 15th, 1916, the plaintiff received from the Standard Oil Company of California certificates representing additional shares of stock amounting to 665 shares; and the defendant alleges that the said Standard Oil Company of California declared a 50 per cent dividend on April 15th, 1916, and a stock dividend of 33⅓ per cent on April 15th, 1917, and that said Standard Oil Company of California, during the years 1908 to 1918, inclusive, paid cash dividends upon its capital stock as follows:

1908	10 %	Cash.
1909	46 %	"
1910	12 %	"
1911	None.	
1912	2½%	"
1913	10 %	"
1914	10 %	"
1915	10 %	"
1916	10 %	"
1917	10 %	"

20 and the defendant further alleges that the weekly range of prices per share of the capital stock of the said Standard Oil Company of California for the years 1913 to 1918, inclusive, which was the fair market value of said shares of stock, is set forth in the table attached hereto as Exhibit A. This table shows the value and market price of said stock before and after the declaration and payment of said dividends.

8. The defendant denies the truth of the matters contained in paragraph 16 of the plaintiff's complaint excepting so much thereof as alleges that the defendant in pursuance of an act of Congress in effect September 9th, 1916, demanded of the plaintiff the sum of $17,689.13 after giving credit to the plaintiff for an excess payment of normal income tax of $67.66, as an income tax on a $150,325.00

profit upon the sale of said International Navigation Company and said International Mercantile Marine Company bonds, and $12,019.41, which is 18.0743 per cent of the face or par value of the 665 shares of stock of the Standard Oil Company of California received by the plaintiff in the year 1916, which said sum of $150,825.00 and $12,019.41 defendant alleges constituted taxable income of the plaintiff, and the defendant further admits the payment of the sum of $17,689.13 on or about July 19th, 1918.

9. The defendant denies the truth of the matters contained in paragraph 20 of the plaintiff's complaint excepting so much thereof as alleges that no part of said sum of $17,689.13 or said sum of $67.66 has been repaid to the plaintiff.

DEFENDANT,
By ALLAN K. SMITH,
Assistant U. S. Attorney.

21 United States District Court, District of Connecticut.

FREDERICK F. BREWSTER, PLAINTIFF,
vs.
JAMES J. WALSH, COLLECTOR OF INTERNAL REVENUE, defendant. } Law. No. 2133.

REPLY.

1. So much of paragraph 4 of the defendant's answer as states "the annual range of prices for said bonds during the years 1912, 1913, and 1914," is admitted.

2. So much of paragraph 4 of said answer as states "it thus appears that the price on March 1st, 1913, was not depressed," is denied.

3. So much of paragraph 6 of said answer as states, "the annual range of prices of said bonds during the years 1912, 1913, 1914, and 1915," is admitted.

4. So much of paragraph 6 of said answer as alleges "it thus appears that the price on March 1st, 1913, was not depressed," is denied.

5. The plaintiff admits the truth of the affirmative allegations contained in paragraph 7 of said answer and the exhibit therein referred to.

FREDERICK F. BREWSTER,
Plaintiff.
By HENRY F. PARMELEE,
His Attorney.

May 20th, 1920.

22 United States District Court, District of Connecticut.

FREDERICK F. BREWSTER, PLAINTIFF,
v.
JAMES J. WALSH, COLLECTOR OF INTERNAL REVENUE, defendant. } LAW. No. 2133.

STIPULATION.

The parties to the above-entitled cause hereby stipulate and agree that the following statement shall be considered as a statement of facts to be used in evidence on trial of said cause without precluding the right of either party thereto to refer to the pleadings on file or to object to the materiality of any fact stated therein.

Statement of facts.

1. Frederick F. Brewster, the plaintiff herein, is a citizen of the State of Connecticut and subject to the valid provisions of the income tax law in effect September 8th, 1916, entitled "An act to increase the revenue and for other purposes."

2. The defendant is and has been the collector of internal revenue of the United States for the State of Connecticut since September 1st, 1913.

3. The plaintiff is not and was not at any of the times herein mentioned, a member of any stock exchange or other similar or-
23 ganization or association for the purpose of trading in or buying or selling securities, nor was he a trader or dealer in stock or bonds or engaged in the business of buying or selling stocks or bonds otherwise than as an investor, and as such occasionally purchasing stocks and bonds for investment, and occasionally buying and selling for the purpose of changing investments.

4. On or about April 19, 1899, the plaintiff became the owner of $191,000 face value of certain interest-bearing bonds of International Navigation Company, a domestic corporation, the said bonds being described as first mortgage sinking fund bonds. These bonds were then of the value of $191,000 and were obtained by the plaintiff in exchange for various securities of the same corporation of the value of $191,000, which the plaintiff had obtained by inheritance. The plaintiff continued to own said bonds until 1916, when he sold the same for $191,000, being the face value thereof.

5. On March 1st, 1913, the first mortgage sinking fund bonds of International Navigation Company were quoted in the market at 79½ per cent asked and no bids, meaning that certain of said bonds were offered for sale in the market at 79½ per cent of their face value, and the annual range of prices for said bonds during the years 1912, 1913, and 1914 stated in percentage of their face values, was as follows:

1912.

High---------- 82½ (April). Low---------- 75¼ (October).

1913.

High---------- 79¼ (January). Low---------- 75 (November).

1914.

High---------- 77½. Low---------- 71½.

24 6. The plaintiff, pursuant to an underwriting agreement to which he was a party, was allotted a participation of $257,000, and paid to the underwriting syndicate during the years 1902 and 1903 the sum of $257,000 in cash. The plaintiff received nothing by way of interest or otherwise from such payment until March 6th, 1906, when he received $257,000 face value in first mortgage bonds of the International Mercantile Marine Company, 5% of the amount of the $257,000 subscription in 6% preferred stock in the same company, less 20% of the same which was allotted to the managers of the syndicate, and 50% of the amount of his subscription of $257,000 in common stock of the same corporation, less 20% of the same which was assigned to the syndicate managers. It is agreed that by this transaction the plaintiff paid in cash during the years 1902 and 1903, 90% of the face value thereof for said first mortgage bonds, to wit, $231,300, the balance of said payment of $257,000 being for the stock received therewith.

It is further agreed that if interest at the rate of 6% per annum during the period between the payment on the underwriting agreement and the allotment of securities is a part of the cost of said bonds, the cost thereof to the plaintiff was 106 $\frac{7}{10}$ths per cent of the face value thereof, to wit, $272,934. If such interest does not constitute a part of the cost of said bonds to the plaintiff the cost thereof was 90% of the face value thereof, to wit, $231,300.

The plaintiff continued to own all of said bonds until 1916 when he sold $100,000 face value thereof at 107¾ per cent of their face value, viz, $107,375.00, and the remainder, viz. $157,000 face value at 107½ per cent of their face value, viz, $168,775.00.

25 7. On March 1st, 1913, the market quotation of the first mortgage bonds of International Mercantile Marine Company was 64 bid and 64½ asked, meaning that certain of said bonds were offered for sale at 64½ per cent of their face value and that an offer or offers were made to purchase same at 64 per cent of their face value, and the annual range of prices of said bonds during the years 1912, 1913, 1914, and 1915 stated in percentage of their face value, was as follows:

1912.

High------70⅜ (March). Low------ 63 (April).

1913.

High------ 66¼ (January). Low------ 56½ (June).

1914.

High------ 61 (January). Low------ 29¼ (December).

1915.

High------ 97½ (December). Low------ 30¼ (January).

8. On March 1st, 1913, and for a long time prior thereto, the plaintiff had been the owner of 1,330 shares of the capital stock of the Standard Oil Company of California. On January 1st, 1916, the Standard Oil Company of California was and had been for many years, and still is, a corporation organized and existing under and by virtue of the laws of the State of California, and on said date had an authorized capital stock of $100,000,000.00 divided into 1,000,000 shares of the nominal or par value of $100 each, and said corporation then had issued and outstanding stock of the nominal or par value of $49,686,656.00. On said date the said corporation had surplus assets and undivided profits amounting to the sum of $44,852,263.02, of which $20,353,068.34 had been earned by said
26 corporation prior to March 1st, 1913, and the balance of said surplus and undivided profits had been earned by said corporation subsequent to that date.

9. The board of directors of the Standard Oil Company of California at a meeting held on the 16th day of January, 1916, determined to issue additional shares of stock constituting a stock dividend of 50 per cent upon its outstanding capital stock from the authorized capital stock of said company, and to transfer from surplus account to capital stock account an amount equivalent to said stock dividend. The said board of directors adopted a resolution declaring said dividend as follows:

"Whereas the issued capital stock of this corporation consists of $496{,}866\ \frac{545{,}614}{983{,}383}$ shares of a par value of one hundred dollars ($100) each; and

"Whereas the unissued capital stock of this corporation consists of $503{,}133\ \frac{437{,}769}{983{,}383}$ shares;

"Whereas the net assets of this corporation exceed the par value of the issued capital stock by far more than twenty-five million dollars ($25,000,000) and the surplus of this corporation is greatly in excess of twenty-five million ($25,000,000) dollars, and

"Whereas said surplus was derived from earnings of the corporation and profits of the business; Now, therefore, be it

"Resolved, That subject to the approval of the said authorities, a stock dividend of $248{,}433\ \frac{272{,}807}{983{,}383}$ shares of the capital stock of this corporation, of the par value of one hundred ($100) dollars each be

and the same is hereby declared, payable on April 15th, 1916, or as soon thereafter as delivery can be made, to the stockholders of
27 this corporation of record on its books at close of business March 4th, 1916, in the proportion of one-half of a share for each share of stock then so owned and held by each of said stockholders as shown by said books.

"*Resolved further*, That the president and secretary of this corporation are hereby authorized and empowered to take whatever steps they may deem necessary to carry this resolution into effect and to notify the stockholders of the purport thereof."

10. Thereafter in accordance with said resolution the officers of said Standard Oil Company of California transferred from surplus account to capital stock account the sum of $24,843,327.74, being the equivalent of said stock dividend, and on or about the 15th day of April, 1916, issued to the stockholders of record of the said corporation on the 4th day of March, 1916, additional shares of stock in the proportion of one share of new stock for each two shares of old stock held by each shareholder on said date.

11. On March 4th, 1916, the plaintiff was the owner of 1,330 shares of stock of the Standard Oil Company of California and on or about the 15th day of April, 1916, in accordance with the aforesaid action of said corporation the plaintiff received from the Standard Oil Company of California certificates representing additional shares of stock amounting to 665 shares of a par value of $100.00 per share and an actual and market value of approximately $250.00 per share.

12. The hereinbefore described stock dividend is the stock dividend which was before the Supreme Court in Macomber v. Eisner, decided March 8, 1920.

13. By resolution of the board of directors of the Standard Oil Company of California the said sum of $24,843,327.74, equal
28 to the par value of the shares of stock constituting the said stock dividend and charged from surplus account to capital account was to the amount of $20,353,068.34 charged against surplus and undivided profits of said corporation earned prior to March 1st, 1913, and the balance thereof amounting to $4,490,259.40 was charged against the first surplus profits of said corporation earned after March 1st, 1913, the result being that 18.0743 per cent of $24,843,327.74 was charged against surplus and undivided profits earned since March 1st, 1913.

14. The plaintiff in the year 1917 filed a return of income received during the year 1916 and paid a tax assessed by the defendant as collector of internal revenue for the District of Connecticut thereon. In determining the amount of taxable income received by the plaintiff during the year 1916 and in ascertaining and fixing the income tax due thereon, plaintiff excluded the sums received by him from the sale of the aforesaid $191,000.00 face value of first mortgage sinking fund bonds of the International Navigation Company, the sums received from the sale of said $257,000.00 face value of the

first mortgage bonds of International Mercantile Marine Company, and the said 665 shares of stock of the Standard Oil Company of California, but plaintiff attached to his said return and filed therewith a statement describing the said transactions and asserting that no taxable income was derived therefrom.

15. The defendant in pursuance of an act of Congress in effect September 8th, 1916, demanded of the plaintiff the sum of $17,689.13 after giving credit to the plaintiff for an excess payment of normal income tax of $67.66 as an income tax on a $150,825.00 profit upon the same of said International Navigation Company and said
29 International Mercantile Marine Company bonds, and $12,019.41, which is 18.0743 per cent of the face or par value of the 665 shares of stock of the Standard Oil Company of California received by the plaintiff in the year 1916, and the defendant further admits the payment of the sum of $17,689.13 on or about July 18th, 1918, under protest, which sum has not been repaid to the plaintiff.

16. The said Standard Oil Company of California declared a 50% stock dividend on January 15, 1916, payable April 15, 1916, to stockholders of record of March 4, 1916, and on or about January 15, 1917, declared a 33⅓% stock dividend, payable April 16, 1917, to stockholders of record of February 15, 1917. The said Standard Oil Company of California during the years 1908 to 1918, inclusive, paid each dividends upon its capital stock as follows:

1908		
1909	10%	cash.
1910	46%	"
1911	12%	"
1912	None.	
1913	2½%	"
1914	10%	"
1915	10%	"
1916	10%	"
1917	10%	"

The weekly range of prices per share of the shares of the capital stock of said Standard Oil Company of California from March, 1913, to 1918, inclusive, which was the fair market value of said shares of stock, is set forth in the table attached to the Answer as filed herein as Exhibit "A." This table shows the fair value
30 and market price of said stock before and after the dates fixed for closing transfer books in the above mentioned declarations of stock dividends, i. e., March 4, 1916, and February 15, 1917. The fair value of said stock per share on March 1st, 1913, did not exceed $173.00. The fair value of said stock at the present time is not less than $320 per share on June 7, 1920.

17. Thereafter the plaintiff took an appeal to the Commissioner of Internal Revenue and demanded repayment of said tax in accordance with law and the regulations and rules of the Treasury Department. Said appeal was duly perfected and filed with the Commis-

sioner of Internal Revenue on or about the 14th day of September, 1918, and thereafter on or about the 21st day of January, 1919, said Commissioner of Internal Revenue refused to grant said appeal and rejected plaintiff's claim for a refund of said sum of $17,689.13 paid as aforesaid, or any part thereof.

HENRY F. PARMELEE,
Attorney for the Plaintiff.
ALLAN K. SMITH,
Assistant U. S. Attorney.

30] United States District Court, for the District of Connecticut.

FREDERICK F. BREWSTER, PLAINTIFF,
against
JAMES J. WALSH, COLLECTOR OF INTERNAL REVENUE, defendant. } LAW. No. 2133.

STIPULATION.

In the above entitled cause it is hereby stipulated by and between the attorneys for the respective parties that the case be tried to the court without a jury, both parties hereby waiving jury trial of the issues herein.

HENRY F. PARMELEE,
Attorney for Plaintiff.
ALLAN K. SMITH,
Attorney for Defendant.

May 18, 1920.

31 District Court of the United States, District of Connecticut.

FREDERICK F. BREWSTER
vs.
JAMES J. WALSH, COLLECTOR OF INTERNAL REVENUE. } No. 2133. At law.

Henry F. Parmelee, Esq., New Haven, Conn.; George D. Watrous, Esq., New Haven, Conn., for plaintiff.
Edward L. Smith, Esq., United States attorney; Allan K. Smith, Esq., Ass't United States attorney, for defendant.

THOMAS, District Judge:

This action arises under the income tax law of 1916. The plaintiff seeks to recover of the defendant, who is collector of internal revenue for the district of Connecticut, $17,689.13, which amount the plaintiff paid to the Government under protest, as an additional income tax assessed against him for the year ending December 31, 1916. The plaintiff further claims that there is also due him the additional sum

of $67.66 which the Government concedes was an over-payment of normal tax and is rightly due the plaintiff, so that the total amount claimed by the plaintiff is $17,756.79. Trial by jury was waived, and the case was tried to the court.

The facts are stipulated. It appears that the plaintiff is not now nor was he during the times mentioned herein, a member of any stock exchange, or of any similar organization or association engaged in the business of trading in, buying, or selling securities. Neither was he in any way engaged in the business of buying or selling stocks and bonds, otherwise than occasionally making purchases of
32 stocks and bonds for investment purposes, and occasionally making sales of such stocks and bonds for the purpose of changing the character of his investments. It further appears that there are three transactions involved in the main points raised in this suit.

The first transaction concerns the bonds of the International Navigation Company. In 1899 the plaintiff acquired certain interest bearing bonds of that company of the face value of $191,000 in exchange for other securities of the same corporation, and during the year 1916 he sold the same bonds for $191,000. On March 1, 1913, these bonds were quoted in the market at 79½ of their face value, so that on that day the market value of the bonds was $151,845. The tax sought to be collected by the Government on this transaction is based upon the difference between the sale price and the market price of the bonds on March 1, 1913, to wit, $39,155, which amount the commissioner taxed as income for the year 1916, and is part of the tax paid under protest which plaintiff seeks to recover in this suit.

The second transaction concerns certain bonds of the International Mercantile Marine Company. In 1903, plaintiff, as a member of an underwriting syndicate, was granted an allotment of mortgage bonds of the face value of $257,000, in return for which he paid the company at that time $231,300 in cash, but the bonds thus allotted were not delivered to the plaintiff until April, 1906, when he received them with nothing by way of interest on the amount of cash he had turned over to the company in 1903. The plaintiff claims that interest at 6% for three years on $231,300 is properly an element of cost and attributable thereto.
33 It becomes necessary at this point to digress from a statement of the facts and first dispose of plaintiff's claim for interest on this transaction, in order to determine what the bonds actually cost the plaintiff, as the actual cost must be determined before consideration can be given to the plaintiff's claims respecting the tax the commissioner assessed and which plaintiff paid under protest, pursuant to such assessment. Plaintiff's claim that interest computed from date of payment in 1903 to date of receipt of bonds in 1906, and added to the cash paid for the bonds represents the real cost of the bonds to the plaintiff is untenable.

In Hays vs. Gauley Mountain Coal Co., 247 U. S., 189, one of the questions there presented was whether the respondent should be allowed to add interest to the amount of cash it had paid in 1902 for certain shares of the capital stock of another mining company which shares it sold in 1911, but the Supreme Court held that there was "no merit in the contention that interest should be added to the purchase price in order to ascertain its cost," so that I find that the actual cost of these bonds to the plaintiff was $231,300.

From the stipulation it further appears that the plaintiff sold the bonds in 1916 for $276,150, part of them having been sold at 107½ and part at 107¼. But on March 1, 1913, the market quotation and market value of these bonds was 64 bid and 64½ asked and at such quotation had an actual market value of $164,480. On this transaction the plaintiff failed to make an income tax return as to any profit or gain by him obtained on the sale of these bonds and was later assessed an additional tax on $111,670 on the ground that this was the representative gain shown by the difference be-
34 tween $164,480, the value of said bonds as indicated by the market quotation of March 1, 1913, and $276,150, the price which plaintiff received from the sale of the bonds in 1916. The tax which was assessed on this transaction by the commissioner, and paid under protest, and which is part of the tax here sought to be recovered, was levied upon the sum of $111,670, which amount the Government claims represents the income received from the sale of these bonds and which amount, as stated above, was the difference between the market value of the bonds on March 1, 1913, and the sum received for them when sold in 1916.

The third transaction relates to a stock dividend declared by the Standard Oil Company of California in which company the plaintiff owned 1,330 shares of its capital stock. In 1916 the plaintiff received 665 shares of stock of said company as a stock dividend declared against a surplus, 18.0754% of which had been earned after March 1, 1913. The Government claims that the plaintiff derived $12,019.41 taxable income therefrom, but this claim has been decided adversely to the Government in Eisner vs. Macomber, 252 U. S., 189, where the identical stock dividend was under consideration, so that the plaintiff, upon that authority, is entitled to recover for the tax assessed and collected in connection with this transaction.

The discussion is therefore narrowed to two transactions, those pertaining to—

(a) The International Navigation Company bonds,
(b) The International Mercantile Marine Company bonds,

both of which the plaintiff owned on and before March 1, 1913, and which he sold in 1916, in accordance with the conditions above set forth. So that the sole inquiry here is, whether the difference
35 in the amounts between the value of investment securities on March 1, 1913, and the amounts received for such securities when sold in 1916 is taxable income within the income tax law of 1916 (39 Stat., c. 463, pp. 756, 757).

The discussion of this proposition revolves around the sixteenth amendment of the Constitution and the legislation passed by the Congress after the ratification of the amendment.

The sixteenth amendment to the Constitution provides:

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The pertinent sections of the statute passed by the Congress to carry the amendment into effect provide:

"Sec. 1. (a) That there shall be levied, assessed, collected, and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income."

"Sec. 2. (b) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: Provided, That the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value."

36 It is thus apparent that the statute specifically imposes a tax upon net income which "shall include gains, profits, and income derived from * * * sales or dealings in property," and then provides:

"(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived."

It is the contention of the plaintiff that the statute is unconstitutional in so far as it taxes as income the increased value of investments when realized by sale, and that such a tax is a direct tax upon capital or property not authorized by the sixteenth amendment and not a tax upon income. In other words, that such gains do not come

within the definition of income as the word is used in the sixteenth amendment.

On the other hand, it is the contention of the Government that such gains do constitute income properly taxable under the income tax law of 1916.

We are therefore brought to a consideration of the scope of the sixteenth amendment, because there is no question but that prior to the adoption of this amendment the Congress had no power whatever to tax as income gains arising from the sale of property where the owner thereof was not a dealer or trader in such property so as to justify an excise tax upon his business.

In support of this, reference is made to the decision of the Supreme Court in Pollock v. Farmers' Loan & Trust Co., 158 U. S., 601. The conclusion stated by Chief Justice Fuller, on page 637, is as follows:

37 "Taxes on personal property, or on the income of personal property, are likewise direct taxes," and that "the tax imposed by sections twenty-seven to thirty-seven, inclusive, of the act of 1894, so far as it falls on the income of real estate and of personal property, being a direct tax within the meaning of the Constitution, and therefore unconstitutional and void because not apportioned according to representation, all those sections * * * are necessarily invalid."

In Eisner v. Macomber, supra, Mr. Justice Pitney, speaking of the Pollock case, said on page 205:

"It was held that taxes upon rents and profits of real estate and upon returns from investments of personal property were in effect direct taxes upon the property from which such income arose, imposed by reason of ownership; and that Congress could not impose such taxes without apportioning them among the States according to population, as required by Article I, section 2, clause 3, and section 9, clause 4, of the original Constitution."

The sixteenth amendment does not extend the taxing power to new subjects. In Evans v. Gore, 253 U. S., 245, at page 261, Mr. Justice Van Devanter in delivering the opinion of the Supreme Court said:

"Thus the genesis and words of the amendment unite in showing that it does not extend the taxing power to new or excepted subjects, but merely removes all occasion otherwise existing for an apportionment among the States of taxes laid on income, whether derived from one source or another."

And again in Eisner vs. Macomber, supra, at page 206, Mr. Justice Pitney, in discussing the scope of the amendment, said:

"As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the States of taxes laid on income. Brushaber v. Union Pacific R. R. Co., 240 U. S., 1, 17–19; Stanton v. Baltic Mining Co., 240 U. S., 103, 112 et seq.; Peck & Co. v. Lowe, 247 U. S., 165, 172–173.

"A proper regard for its genesis, as well as its very clear language, requires also that this amendment shall not be extended by
38 loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overrid'en by Congress or disregarded by the courts.

"In order therefore that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified by the amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income,' as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress can not by any definition it may adopt conclude the matter, since it can not by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

In the case at bar it therefore "becomes essential to distinguish between what is and what is not 'income' as the term is used in the sixteenth amendment * * * and to apply the distinction according to truth and substance without regard to form," in order that Article I of the original Constitution, section 2, clause 3, and section 9, clause 4, may have proper force and effect save only as modified by the sixteenth amendment.

The question therefore is simply this: Is a gain in value realized from the sale of property income?

Insisting with great earnestness, with persuasive argument, and the citation of cases alleged to be in support of its argument, the Government contends that the answer is—Yes. The plaintiff, with equal forcefulness, contends that the answer is—No.

But the cases relied upon by the Government arose under the corporation tax act of 1909 and not under an income tax law. The corporation tax act of 1909, as held by the Supreme Court in Strat-
ton's Independence v. Howbert, 231 U. S., 399, 414, 416, was not
39 an income tax law, and since gains by sales were specifically included as taxable, the cases decided under that act do not determine the definition of the word "income" within the sixteenth amendment and so are not apposite to the instant case.

Mr. Justice Pitney, in the Stratton's Independence case, supra, on page 414, said:

"As has been repeatedly remarked, the corporation tax act of 1909 was not intended to be and is not in any proper sense an income tax law. This court had decided in the Pollock case that the income tax law of 1894 amounted in effect to a direct tax upon property, and was invalid because not apportioned according to population as prescribed by the Constitution. The act of 1909 avoided this difficulty by imposing not an income tax but an excise tax upon the conduct of business in a corporate capacity, measuring, however, the

amount of tax by the income of the corporation, with certain qualifications prescribed by the act itself. Flint v. Stone-Tracy Co., 220 U. S., 107; McCoach v. Minehill Co., 228 U. S., 295; United States v. Whitridge (decided at this term, ante, p. 144)."

And again on page 416 he said:

"As to what should be deemed 'income' within the meaning of sec. 38, it, of course, need not be such an income as would have been taxable as such, for at that time (the sixteenth amendment not having been as yet ratified), income was not taxable as such by Congress without apportionment according to population, and this tax was not so apportioned. Evidently Congress adopted the income as the measure of the tax to be imposed with respect to the doing of business in corporate form because it desired that the exercise should be imposed, approximately at least, with regard to the amount of benefit presumably derived by such corporations from the current operations of the Government. In Flint v. Stone-Tracy Co., 220 U. S., 107, 165, it was held that Congress, in exercising the right to tax a legitimate subject of taxation as a franchise or privilege, was not debarred by the Constitution from measuring the taxation by the total income, although derived in part from property, which, considered by itself, was not taxable. It was reasonable that Congress should fix upon gross income, without distinction as to source, as a convenient and sufficiently accurate index of the importance of the business transacted."

See also Anderson v. Forty-Two Broadway, 239 U. S., 69, 72;
40 Stanton v. Baltic Mining Co., 240 U. S., 103, 114; Von Baumbach v. Sargent Land Co., 242 U. S., 503, 522; Doyle v. Mitchell Bros. Co., 247 U. S., 179, 183.

The question before us was passed upon by the Supreme Court under the income-tax law of 1867 in Gray v. Darlington, 15 Wallace, 63, and this precise question has not been before the Supreme Court since that decision. There it was decided that under the law of 1867 a gradual increase in value extending over a period of years could not be taxed as income for the year in which it was realized by sale. Speaking for the court, Mr. Justice Field, on page 65, said:

"The question presented is whether the advance in the value of the bonds, during this period of four years, over their cost, realized by their sale, was subject to taxation as gains, profits, or income of the plaintiff for the year in which the bonds were sold. The answer which should be given to this question does not, in our judgment, admit of any doubt. The advance in the value of property during a series of years can, in no just sense, be considered the gains, profits, or income of any one particular year of the series, although the entire amount of the advance be at one time turned into money by a sale of the property. The statute looks, with some exceptions, for subjects of taxation only to annual gains, profits, and income."

And further, on page 66:

"The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of

the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital."

Respecting this decision, the Supreme Court in Lynch v. Turrish, 247 U. S., 221, speaking by Mr. Justice McKenna, said on page 230, after discussing Gray v. Darlington:

"This case has not been since questioned or modified," and meets the Government's attempt to distinguish Gray v. Darlington, on page 230, in the following manner:

41 "The Government, however, makes its view depend upon disputable differences between certain words of the two acts. It urges that the act of 1913 makes the income taxed one 'arising or accruing' in the preceding calendar year, while the act of 1867 makes the income one 'derived.' Granting that there is a shade of difference between the words, it can not be granted that Congress made that shade a criterion of intention and committed the construction of its legislation to the disputes of purists. Besides, the contention of the Government does not reach the principle of Gray v. Darlington, which is that the gradual advance in the value of property during a series of years in no just sense can be ascribed to a particular year, not therefore as 'arising or accruing,' to meet the challenge of the words, in the last one of the years, as the Government contends, and taxable as income for that year or when turned into cash. Indeed, the case decides that such advance in value is not income at all, but merely increase of capital and not subject to a tax as income."

The meaning of the word "incomes" in the sixteenth amendment is no broader than its meaning in the act of 1867. It was adopted in its present form, using only the words "incomes from whatever source derived" with the presumptive knowledge on the part of Congress and the several State legislatures, of the meaning attributed thereto by the decisions of the various courts, both State and Federal.

It has been held repeatedly that gains realized from the sale of capital assets held in trust are not income, but are principal—exactly as the securities were before they were sold, and that where a tenant for life is entitled to the entire net income of a fund, and the trustee realizes an advance in value by the sale of an investment, the life tenant is not entitled to the gain which is uniformly treated by the courts as an increment to principal and a part of the corpus of the trust.

The following are a few of the leading cases sustaining the doctrine that the growth or increase of value when realized on the sale

42 of an investment is accretion to capital and not income as between life tenant and remainderman: Boardman v. Mansfield, 79 Conn., 634; Carpenter v. Perkins, 83 Conn., 11, 20; Parker v. Johnson, 37 N. J. Eq., 366, 368; Outcault v. Appleby, 36 N. J. Eq., 74, 78; Matter of Gerry, 103 N. Y., 445; Thayer v. Burr, 201 N. Y., 155, 157, 158; Graham's Estate, 198 Pa. St., 216; Neele Estate (No. 2), 207 Pa. St., 446; Lauman v. Foster, 157 Iowa, 275; Slocum v. Ames,

19 R. I., 401; Jordan v. Jordan, 192 Mass., 337; Mercer v. Buchanan, 132 Fed., 501, 508.

These decisions had at the time of the adoption of the sixteenth amendment, established a definite meaning of the word "income" for the purpose of statutory and constitutional construction. It is difficult to see how the word "income" can have any different meaning when applied to the proceeds of an investment when held by a trustee than when held by an individual, as the income-tax law specifically refers to funds held in trust. (Sec. 2 (b).)

In order to show the conclusions reached by the courts it will suffice to quote from only one of the cases to which reference is made, supra. In Parker v. Johnson, 37 N. J. Eq., 366, the court said:

"The profit is not income. It was made by the trustee in the process of converting the investment, and, like a premium realized on the sale of Government bonds in which the funds might be invested, it belongs to the fund. The trustee in this case is to keep the fund invested, and the tenant for life is entitled to the interest. It is clearly the duty of the trustee to apply the profits on one investment to making up the losses on others."

So it seems that income from investments consists, in the case of bonds, of interest; in the case of stocks, of dividends. There is no income from the sale of investments.

43 The conclusion seems imperative that the word "income" has a well-defined meaning, not only in common speech but also under judicial construction, and this meaning does not include the increase in value of capital assets when realized upon a sale.

The following extract from the opinion of Mr. Justice Pitney in the Macomber case, supra, at page 206, is instructive:

"For the present purpose we require only a clear definition of the term 'income' as used in common speech, in order to determine its meaning in the amendment."

It seems to be apparent that the Supreme Court, in Towne v. Eisner, 245 U. S., 418, 426, and in Eisner v. Macomber, supra, followed the doctrine enunciated in Gibbons v. Mahon, 136 U. S., 549, where it was held that a stock dividend is an accretion to capital and not income as between a life tenant and the remainderman, and therefore held in the Towne case that a stock dividend was not income within the meaning of the income tax law of 1913, and in the Macomber case that such a stock dividend was not income within the meaning of the sixteenth amendment. As already stated, it is difficult to see why any different rule should be applied to the proceeds of an investment—purely a capital investment—when held by a trustee than when held by an individual.

Two pertinent points have been definitely established by the Supreme Court in Eisner v. Macomber, supra, page 214:

First. "Enrichment through increase in value of capital investment is not income in any proper meaning of the term."

and

Second. "If it requires conversion of capital in order to pay the tax, it must follow that the tax is on capital increase and not on income, for on page 213 the court said:

44 "Yet, without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax."

Had the plaintiff possessed no resources other than the bonds which he sold—prior to the sale his capital would have been their then entire value. The increase since March 1, 1913, was capital increase. To collect the tax on this increase in value because the capital was converted into cash must of necessity diminish his capital to that extent. Before the sale all the plaintiff possessed was capital without any part of it constituting income. The sale of capital results only in changing its form, and like the mere issue of a stock dividend, makes the recipient no richer than before. Gibbons v. Mahon, supra; Towne v. Eisner, supra; Eisner v. Macomber, supra.

The exact question presented in this case has not been before the Supreme Court since its decision in Gray v. Darlington, supra, nor did it arise in Eisner v. Macomber, supra. Notwithstanding certain passages in the opinion of the court in the Macomber case stating that when dividend stock is sold at a profit, the profit is taxable like other income—which I consider, in view of all that has been written by the Supreme Court in a long line of income tax decisions, must mean that the profit derived from such transactions, if it is income, applies in the case of a trader and not in the case of an individual who merely changes his investments.

Therefore, under the authority of Gray v. Darlington, which is approved in Lynch v. Turrish, supra, I feel constrained to

45 hold that the appreciation in value of the plaintiff's bonds, even though realized by sale, is not income taxable as such, and in reaching this conclusion I find support for it in the Macomber case, where Mr. Justice Pitney says:

"Enrichment through increase in value of capital investment is not income in any proper meaning of the term."

It follows that the income tax law of 1916, in so far as it attempts to tax such increase, is in conflict with the apportionment requirements of the first article of the Constitution, being a direct tax and not apportioned among the several States according to population.

Counsel for plaintiff contended that the act should be so construed as to limit the tax to the actual increase from the dates of acquisition, although the value of such bonds was less on March 1, 1913, than when acquired prior thereto, in the event that the gain in value of the bonds when sold was taxable at all. In view of the decision that such increases are not income it becomes unnecessary to discuss the point.

The conclusion herein expressed has been reached only after a very careful consideration of all the respective claims presented by able counsel in exhaustive and persuasive briefs and with full appreciation of the admonition given by the Supreme Court in Nicol v. Ames, 173 U. S., 509, at page 514. This court fully appreciates that—

"It is always an exceedingly grave and delicate duty to decide upon the constitutionality of an act of the Congress of the United States,"

and that—

"the duty imposed demands in its discharge the utmost deliberation and care and invokes the deepest sense of responsibility"—

as was said by Chief Justice Fuller in the opening paragraph
46 of the opinion in Pollock v. Farmers' Loan & Trust Co., 158 U. S., 601, at page 617. In the discharge of that duty, as I see it, it follows that the word "incomes" in the sixteenth amendment should not and can not be so construed as to include property other than income even if such property is described as income by an act of Congress, as such a construction permits the Congress to nullify the provisions of the second section of Article I of the Constitution, that direct taxes shall be apportioned.

Let judgment be entered for the plaintiff to recover of the defendant $17,756.79, with interest on the same from July 19, 1918, together with costs of suit.

Ordered accordingly.

(Signed) THOMAS, *D. J.*

December 16, 1920.

47 United States District Court, District of Connecticut.

At a stated term of the District Court of the United States for the District of Connecticut, held at the United States courthouse in the city of Hartford, State of Connecticut, in said district, on the 16th day of December, A. D. 1920.

Present: The Honorable Edwin S. Thomas, judge.

FREDERICK F. BREWSTER, OF NEW HAVEN, in the State and District of Connecticut, plaintiff.	
vs.	
JAMES J. WALSH, COLLECTOR OF INTERNAL revenue of the United States for the district of Connecticut, of Hartford, in the State and District of Connecticut, defendant.	No. 2133. At law.

JUDGMENT.

This action by complaint claiming $17,756.79 damages with interest thereon from the 19th day of July, 1918, came to this court on the first Monday in March, 1919, and thence by continuance to

the eighth day of June, when the parties appeared by their respective attorneys and were at issue as on file, and filed herein an agreed statement of facts entitled "Stipulation and statement of facts" and signed by the attorneys for the plaintiff and defendant, respectively, which agreed statement of facts is ordered to be filed and made a part of the record in this cause, and the facts therein set forth are found to be facts.

And thereupon, neither party desiring to introduce additional evidence, and the parties having waived a jury, by consent of the
48 parties this cause was submitted to the court, in lieu of a jury, upon said stipulation of facts, the pleadings and upon argument and briefs of counsel; upon consideration whereof the court is of opinion to and doth find the issues for the plaintiff and assess his damages at $17,756.79, together with the sum of $2,568.65 interest thereon from July 19th, 1918, at the rate of six per centum per annum, making a total of $20,325.44 as of this date, and the decision of the court is set forth in a written opinion, filed herein and made a part of the record in this cause.

Whereupon it is adjudged that the plaintiff, Frederick F. Brewster, recover of and from the defendant, James J. Walsh, collector of internal revenue, the sum of $20,325.44, with interest thereon from this day until paid.

BY THE COURT.

Attest:

C. E. PICKETT, *Clerk.*

Approved as to form.

Clerk.

ALLAN K. SMITH,
Assistant United States Attorney.

December 16, 1920.

49 In the United States District Court for the District of Connecticut.

FREDERICK F. BREWSTER, PLAINTIFF,
vs.
JAMES J. WALSH, COLLECTOR OF INTERNAL REVENUE, DEFENDANT.

ASSIGNMENT OF ERRORS.

The defendant above named hereby assigns error to the record and proceedings, and to the judgment entered in the above entitled cause as follows:

1. The court erred in ordering the entry of judgment for the plaintiff.

2. The court erred in holding that the difference realized on sales of securities in the year 1916 over their fair market value on the 1st day of March 1913, as set forth in the complaint, answer and

agreed statement of facts were not taxable as income within the intent and meaning of the revenue act of 1916 or of any other applicable act.

3. The court erred in holding that the differences in the amounts between the value of investment securities, i. e., bonds of the International Navigation Company and the International Mercantile Marine Company, on March 1st, 1913, and the amounts received for such securities when sold in 1916, is not taxable income within the income tax law of 1916 or any other applicable act.

4. The court erred in holding that prior to the adoption of
50 the sixteenth amendment to the Constitution of the United States, the Congress had no power whatever to tax as income, gains arising from the sale of property where the owner thereof was not a dealer or trader in such property, so as to justify an excise tax upon his business.

5. The court erred in holding that the meaning of the word "income" does not include the increase in value of capital assets when realized upon a sale.

6. The court erred in holding that the appreciation in value of the plaintiff's bonds, even though realized by sale, is not income taxable as such.

7. The court erred in holding that the tax assessed as alleged in the complaint, answer and agreed statement of facts, and the revenue act of 1916, and any other applicable act, in so far as the same have been or may be construed or enforced as imposing said tax, were unconstitutional and void, and in violation of Article I, section 2, clause 3 of the Constitution of the United States, as a direct tax and not apportioned among the several States according to population.

8. The court erred in holding that the tax assessed as alleged in the complaint, answer and agreed statement of facts, and the revenue act of 1916, and any other applicable act, in so far as the same have been or may be construed or enforced as imposing said tax, were unconstitutional and void, and in violation of Article I, section 9, clause 4 of the Constitution of the United States, as a direct tax not laid in proportion to the census or enumeration therein mentioned.

9. The court erred in holding that the growth or increment of value in property held for investment, when realized by the sale of such property, is not taxable as income under the revenue act
51 of 1916, or under any other applicable act.

10. The court erred in holding that the growth or increment of value in property held for investment, when realized by the sale of such property, is not income within the meaning of the word "incomes" as set forth in the sixteenth amendment to the Constitution of the United States.

11. The court erred in holding that the tax alleged in the complaint, answer, and agreed statement of facts was not a tax on income within the meaning of the revenue act of 1916, or any other applicable act.

12. The court erred in holding that the tax alleged in the complaint, answer, and agreed statement of facts was not a tax on incomes within the meaning of the sixteenth amendment to the Constitution of the United States.

13. The court erred in holding that the revenue act of 1916 or any other applicable act, in so far as the same has been or may be construed and enforced as imposing a tax as set forth in the complaint, answer, and agreed statement of facts, is not authorized by the sixteenth amendment to the Constitution of the United States.

Dated at Hartford, Connecticut, this 3rd day of February, A. D. 1921.

ALLAN K. SMITH,
Assistant United States Attorney,
Attorney for Defendant.

52 District Court of the United States, District of Connecticut.

FREDERICK F. BREWSTER,
vs.
JAMES J. WALSH, COLLECTOR OF INTERNAL REVENUE.

STIPULATION CONCERNING RECORD.

It is hereby stipulated that the record on the writ of error to the District Court of the United States for the District of Connecticut in the above-entitled action consist of the following:

1. Writ or error.
2. Certification of record by clerk.
3. Petition for writ of error.
4. Order allowing writ of error.
5. Complaint.
6. Answer, omitting, however, Exhibit A attached thereto.
7. Reply.
8. Stipulation and statement of facts.
8½. Stipulation waiving jury.
9. Opinion of Hon. Edwin S. Thomas.
10. Judgment.
11. Assignments of error.
12. Stipulation concerning record.
13. Citation.

Dated at New Haven, Connecticut, this 5th day of February, A. D. 1921.

HENRY F. PARMALEE,
Attorney for Plaintiff.
ALLAN K. SMITH,
Assistant U. S. Attorney,
Attorney for defendant.

By the Honorable Edwin S. Thomas, judge of the District Court of the United States for the District of Connecticut, in the Second Circuit, to Frederick F. Brewster, greeting:

You are hereby cited and admonished to be and appear before the United States Supreme Court, to be holden at the city of Washington, within thirty days from the date hereof, pursuant to a writ of error filed in the clerk's office of the District Court of the United States for the District of Connecticut, wherein James J. Walsh, collector of internal revenue, is plaintiff in error and you are defendant in error, to show cause, if any there be, why the proceedings and judgment in said writ of error mentioned should not be corrected and speedy justice should not be done in that behalf.

Given under my hand in the city of New Haven, in the district and circuit above named, this fourth day of February, in the year of our Lord one thousand nine hundred and twenty-one, and of the Independence of the United States the one hundred and forty-fifth.

EDWIN S. THOMAS,
Judge of the District Court of the United States for the District of Connecticut, in the Second Circuit.

Due and legal service of the foregoing citation on appeal is hereby accepted this 4th day of February, 1921.

H. F. PARMALEE,
Attorney for the Plaintiff.

(Endorsement on cover:) File No. 28099. Connecticut, D. C. U. S. Term No. 742. James J. Walsh, collector of internal revenue, plaintiff in error, vs. Frederick F. Brewster. Filed February 16th, 1921. File No. 28099.

Office of the clerk, Supreme Court, U. S. Received Feb. 16, 1921.

MAR 9 1921
JAMES D. MAH
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No. 752.

In the Supreme Court of the United States.

OCTOBER TERM, 1920.

[illegible] WALSH, COLLECTOR OF INTERNAL REVENUE,
Petitioner in Error,

vs.

FREDERICK F. BRIDGHAM.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES
FOR THE DISTRICT OF CONNECTICUT.

BRIEF FOR PLAINTIFF IN ERROR.

In the Supreme Court of the United States

OCTOBER TERM, 1920.

JAMES J. WALSH, COLLECTOR OF INTERNAL REVENUE, plaintiff in error,
v.
FREDERICK F. BREWSTER.

No. 742.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE DISTRICT OF CONNECTICUT.

BRIEF FOR PLAINTIFF IN ERROR.

This case is here on writ of error to review a judgment of the District Court granting a recovery of $17,756.79, paid under protest as income taxes for the year 1916.

THE FACTS.

The amount recovered includes four items, as to only one of which the Government now challenges the correctness of the judgment.

1. A conceded overpayment of $67.66 of the normal tax which was due to the defendant in error. This was not questioned in the court below and is not now questioned.

2. One item of the taxes involved was a tax assessed on $39,159 as profits realized by a sale of bonds

of the International Navigation Company. These bonds were purchased in 1899 for $191,000 and sold in 1916 for exactly the same amount. On March 1, 1913, however, their market value was $151,845. The Commissioner of Internal Revenue ruled that there was taxable income to the amount of the difference between this sum and the selling price of $191,000, and collected taxes on this basis. It is apparent that on the entire transaction there was no gain, since the bonds were sold for the exact amount of their cost, the only returns on the capital invested being the interest collected during the time they were held, which presumably was included in the income of the holder for the years in which received. In the case of *Goodrich* v. *Edwards*, No. 663, which will be under consideration by the court contemporaneously with this case, it has been conceded that where the selling price of property is not in excess of the purchase price there is no taxable gain or income. For this reason the Government can not insist that so much of the judgment as allows recovery for this item of taxes is erroneous.

3. Another item was a tax upon a stock dividend. Since the decision in *Eisner* v. *Macomber*, 252 U. S. 189, it is conceded that this tax was improperly collected.

4. In 1906 the defendant in error purchased bonds of the International Mercantile Marine Company at a cost of $231,300. These bonds were sold in 1916 for $276,150. On March 1, 1913, however, their value

was much lower than the original cost and they were worth only $164,480. The Commissioner of Internal Revenue ruled that the difference between this sum and the selling price was taxable gain or income, and accordingly collected taxes on $111,670. In this transaction the actual gain realized was the difference between the selling price, $276,150, and the cost price, $231,300, or $44,850. Since the value of the property on March 1, 1913, was only $164,480, it can not be said that any part of the increase in value occurred before that date. While it is conceded, therefore, that the defendant in error was not properly taxable on the difference between the March, 1913, value and the selling price, it is contended that he was taxable on the difference between the purchase price and the selling price, or $44,850.

HOLDING OF THE COURT BELOW.

The court below granted a recovery for the full amount claimed upon the ground that profits realized from the sale of capital assets are not income, and that, so far as the act of Congress undertakes to tax them as income. it is unconstitutional. This holding is now challenged.

From the statement of facts made above, however, it follows that the judgment itself is now questioned only to the extent that it denies the Government the right to a tax on $44,850, or the price actually realized on the sale of the International Mercantile Marine Company bonds.

BRIEF.

The argument of the Government in support of the constitutionality of the act taxing profits resulting from the sale of capital assets and the right of the Government to treat as income for the year in which the sale is made that portion of such profits actually realized over and above the purchase price which represents an increase in value accruing between March 1, 1913, and the date of sale, is fully presented in the Government's brief in *Goodrich* v. *Edwards*, No. 663, mentioned above. The argument, therefore, will not be repeated, but that brief is referred to and adopted as the Government's argument in this case.

CONCLUSION.

It is respectfully submitted that the judgment of the court below should be modified to the extent of denying a recovery for the taxes on the item of $44,850 above mentioned.

Respectfully submitted.

WILLIAM L. FRIERSON,
Solicitor General.

MARCH, 1921.

○

FEB 28 1921
JAMES D. MAHER,
CLERK

Supreme Court of the United States.

OCTOBER TERM, 1920.

No. 742.

JAMES J. WALSH, United States Collector of Internal Revenue for the District of Connecticut,

Plaintiff in Error.

v.

FREDERICK F. BREWSTER,

Defendant in Error.

WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE DISTRICT OF CONNECTICUT.

MOTION TO ADVANCE BY DEFENDANT IN ERROR.

HENRY F. PARMELEE,
GEORGE D. WATROUS,
BARRY MORGAN,
Of Counsel for Defendant in Error.

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1920.

No. 742.

JAMES J. WALSH, United States Collector of Internal Revenue for the District of Connecticut,

Plaintiff in Error.

v.

FREDERICK F. BREWSTER,

Defendant in Error.

WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE DISTRICT OF CONNECTICUT.

MOTION TO ADVANCE BY DEFENDANT IN ERROR.

Now comes Frederick F. Brewster, the defendant in error herein, and respectfully moves that the above entitled cause be advanced for early hearing during the present term, and respectfully suggests that it be set down for hearing immediately after the case of Goodrich v. Edwards, No. 663, of the present term, which involves similar questions.

The above entitled writ of error presents to the court for review a judgment rendered on December 16, 1920, adjudging that the plaintiff (the defendant in error) recover of the defendant, the United States Collector of Internal Revenue for the District of Connecticut, moneys paid under protest upon the ground that they had been illegally exacted by the plaintiff in error under color of a tax unlawfully imposed upon the defendant in error. The complaint and the judgment

thereon raise two questions: (1) the constitutionality of so much of the Income Tax Law of 1916 as has been construed to tax, as income, capital increment realized upon the conversion of capital investments into cash after the passage of said act, and (2) the correctness of the construction given to said act. This case differs from the case of Merchants' Loan and Trust Company v. Smietanka, No. 608, heretofore argued at this term, in that the defendant in error in this case was an individual and the question as to the status of realized investment increment arises independently of the provisions of a will defining net income and directing the manner of its use and distribution. This case differs from Goodrich v. Edwards in that an actual increment in value was realized, whereas in Goodrich v. Edwards, the plaintiff in error suffered an actual loss in excess of the sums treated as income and upon which the tax was assessed.

The subject is important, and the courts of first instance have arrived at conflicting results. The District Court for the District of Connecticut has held the statute to be unconstitutional in so far as it is construed to tax as income capital increment realized by conversion of capital investments into cash. Rulings to the contrary have been made by the District Court of the United States for the Southern District of New York, in the case of Goodrich v. Edwards above mentioned and by the District Court of the United States for the Northern District of Illinois in the case of Merchants' Loan and Trust Company v. Smietanka above mentioned.

It is submitted that the public interest will be served by the early hearing of this cause at the same

time as the said case of Goodrich v. Edwards and by the authoritative determinations of the questions at issue.

WHEREFORE, the defendant in error respectfully prays this Honorable Court to advance the above-entitled cause for early hearing during the present term.

All of which as in duty bound is respectfully submitted for the consideration and action of the court.

Notice of this application has been served on the Department of Justice, and on the Solicitor General with copies of brief for defendant in error, ten days prior to the presentation hereof.

We are authorized to state that the Solicitor General offers no objection to this motion.

February 28, 1921.

HENRY F. PARMELEE,
GEORGE D. WATROUS,
BARRY MOHUN,
Of counsel for defendant in error.

Office Supreme Court, U. S.
FILED
FEB 28 1921
JAMES D. MAHER,
CLERK

Supreme Court of the United States.

OCTOBER TERM, 1920.

No. 742.

JAMES J. WALSH, United States Collector of Internal Revenue for the District of Connecticut,

Plaintiff in Error.

v.

FREDERICK F. BREWSTER,

Defendant in Error.

WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE DISTRICT OF CONNECTICUT.

BRIEF AND ARGUMENT FOR DEFENDANT IN ERROR.

WILLIAM D. GUTHRIE,
HENRY F. PARMELEE,
GEORGE D. WATROUS,
BARRY MOHUN,
Of counsel for Defendant in Error.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1920.

No. 742.

JAMES J. WALSH, United States Collector of Internal Revenue for the District of the State of Connecticut,

Plaintiff in Error.

vs.

FREDERICK F. BREWSTER,

Defendant in Error.

WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE DISTRICT OF CONNECTICUT.

BRIEF FOR THE DEFENDANT IN ERROR.

This is a writ of error to the District Court of the United States for the District of Connecticut to review a judgment for the defendant in error (the plaintiff below) rendered December 16th, 1920. The case was tried, without a jury, on the pleadings, and on a stipulated statement of facts. The court below filed an opinion (Record p. 18.)

STATEMENT.

The Record presents the constitutional question whether the increase in value of corporate bonds, originally acquired and held for investment, is taxable as income under the Sixteenth Amendment to the Constitution of the United States, when such bonds are sold. The case differs from Merchant's Loan and Trust Company *v.* Smietanka, No. 608, of the present

term, in that the defendant in error (the plaintiff below) was a natural person who owned the bonds in question directly for his own benefit, and not in trust. It is stipulated, and found by the court below that he was in no way "engaged in the business of buying or selling stocks and bonds, otherwise than occasionally making purchases of stocks and bonds for investment purposes, and occasionally making sales of such stocks and bonds for the purpose of changing the character of his investments." (Record p. 19).

The facts are so fully stated in the opinion of the court below, that we state them here concisely and without detail, as follows:

(a) In 1899, the defendant in error acquired as an investment, $191,000 in face value of bonds of International Navigation Company, a domestic corporation for $191,000. On March 1, 1913, based on market quotations at 79½, the market value of these bonds was $151,845. He continuously retained these bonds as an investment from the date of their acquisition, until he sold them during the year 1916, for their face value, $191,000, their cost in 1899. Based on this transaction a tax was assessed on $39,155.00 as income, this being the difference between the market value of the bonds on March 1, 1913, and the sum received therefor when sold.

(b) In 1906 the defendant in error acquired as an investment $257,000.00 in face value of bonds of International Mercantile Marine Company, as the court below finds, at a cost of $231,300.00. On March 1, 1913, based on market quotations at 64, the market value of these bonds was $164,480.00. These bonds were also retained by the defendant in error as an in-

vestment from 1906 until he sold them during the year 1916 in part at 107⅜ and in part at 107½ for the sum of $276,150.00. On this transaction a tax was assessed on $111,670.00 as income, this representing the difference between the March 1, 1913, market value and the sum received.

(c) The defendant in error received during the year 1916 a stock dividend declared against a surplus, in part earned after March 1, 1913, from Standard Oil Company of California. A tax was assessed upon this dividend stock, which defendant in error had not sold, as constituting income to the amount of $12,019.41. This is the identical stock dividend passed upon by this court in *Eisner v. Macomber*, 252 U. S. 189.

The total amount of tax based upon these three transactions, amounting to $17,756.79, was paid to the plaintiff in error as Collector of Internal Revenue, in the following manner: the sum of $67.66 constituted a conceded over-payment of normal tax which was due to the defendant in error; the balance, $17,689.13, was paid to the plaintiff in error under protest, and an appeal taken to the Commissioner of Internal Revenue, which was denied and suit was thereafter brought. In the court below, the plaintiff below (the defendant in error), claimed that in so far as the Income Tax Act of 1916 purported to tax such investment increment as income, it was unconstitutional and that in any event the act should not be so construed as to tax as income anything in excess of the difference between cost and sale price of investments. The court below sustained the defendant in error on the constitutional question and since the defendant in error had realized a sum in

excess of cost price, the question of statutory construction became immaterial, and the court below did not pass upon it.

The Income Tax Law of 1916 (39 Stat. 756, Ch. 463, Part I) provides, in so far as applicable:

> Section 1 (a). "That there shall be levied, assessed, collected and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income; . . . "
>
> (b). "In addition to the income tax imposed by subdivision (a) of this section (herein referred to as the normal tax) there shall be levied, assessed, collected and paid upon the total net income of every individual . . . . . an additional income tax (herein referred to as the additional tax) . . . . . " (Surtax rates omitted.)
>
> "For the purpose of the additional tax there shall be included as income the income derived from dividends on the capital stock or from the net earnings of any corporation . . . . . "
>
> (c). "The foregoing normal and additional tax rates shall apply to the entire net income, except as hereinafter provided, received by every taxable person in the calendar year nineteen hundred and sixteen and in each calendar year thereafter."
>
> Section 2 (a). "That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form

paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: *Provided*, that the term 'dividends', as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value."

(c). "For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived."

Section 5. "That in computing net income in the case of a citizen or resident of the United States:

(a). For the purpose of the tax there shall be allowed as deductions:

"*Fourth*. Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise:

Provided, That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

"*Fifth*. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom;....."

SUMMARY OF POINTS.

1. Bonds are property without reference to cost or market value. The bonds themselves are their owner's capital assets, and his capital interest therein is not limited to their cost, or to their value as determined by market quotations on a date fixed by an Act of Congress.

2. Increase in value of property held as investment is not income.

3. The sale of an investment realizing an increase in value does not create, or result in the derivation or receipt of, income.

4. Construed to tax as income any part of the proceeds of the sale of a capital investment, the Income Tax Law of 1916, is to that extent invalid as in conflict with Article I, Section 2, Clause 3, and Article I, Section 9, Clause 4 of the Constitution, being a direct

tax on property, and not coming within the provision of the Sixteenth Amendment.

5. Notwithstanding the construction placed thereon by the Commissioner of Internal Revenue, the Income Tax Law of 1916 does not purport to tax the proceeds of the sale of a capital investment or any part thereof as income.

Argument.

I.

Bonds are Property without Reference to Cost or Market Value. The Bonds themselves are their Owner's Capital Assets, and his Capital Interest therein is not Limited to their Cost, or to their Value as Determined by Market Quotations on a Date Fixed by an Act of Congress.

A bond is more than evidence of an initial investment of a capital sum. It is property itself. It is under seal—a specialty—ownership passes by delivery as in case of any chattel. In itself, it is the investor's property equally with his house, without limitation of its value *as capital* to its cost, or to its market value on March 1, 1913. It is his capital, the thing itself, in its entirety. His house is his capital, used to shelter himself and his family. His bonds are capital, purchased to be held as property, to produce a regular recurrent income to support himself and his family. The house and the bonds are in themselves his capital.

Investment bonds, not their cost or former market value, are capital. Their regular recurrent interest payments, not the fluctuations of market values, are income.

The trader in houses or bonds, on the contrary, has a cash capital. He buys, not a capital asset to provide a home or an income for his own use, but a house, or bond, to be sold at the market; his capital asset in each transaction is the amount of cash capital expended from the working capital of his business, and his income is the difference between his aggregate gains and losses less the expenses of his business, covering the period of the year.

This distinction between transactions of a trader and an investor is recognized in the cases hereinafter cited, and in our own legislation.

The Income Tax Law of 1913 (38 Stats. 167, Ch. 16, Sec. II B), permitted the offset of losses in trade to determine net taxable income, but did not permit an investor to offset realized losses. *Mente v. Eisner*, C.C.A. 2nd Cir. 226 Fed. 161.

The Income Tax Law of 1916 (39 Stats. 759) permitted one, in transactions apart from his business, to offset his losses but only to the amount of his gains in similar transactions.

The distinction is constantly applied in excise taxes applicable only to business.

The defendant in error's bonds, therefore, as long as he retained them, were his property, unaffected by the fluctuations in their market value. As his property, they were capital assets in their entirety on the days he sold them. The value of his capital was the market value of the bonds on the days when sold. Each

sale resulted in a transmutation of capital from bonds to cash to the amount of their exact value on that day.

II.

Increase in Value of Property Held as Investment Is Not Income.

> "Enrichment through increase in value of capital investment is not income in any proper meaning of the term." *Eisner v. Macomber*, 252 U.S. 189, 214-215.
>
> "Mere advance in value in no sense constitutes the gain, profits, or income specified by the statute. It constitutes and can be treated merely as an increase of capital." *Gray v. Darlington*, 15 Wall. 63, 66. Affirmed in *Lynch v. Turrish*, 247 U.S. 221.

III.

The Sale of an Investment Realizing an Increase in Value Does Not Create, or Result in the Derivation or Receipt of, Income.

This question had frequently arisen between beneficiaries of trust funds who were entitled to entire net incomes for life, and trustees and remaindermen, and prior to the adoption of the Sixteenth Amendment, it had been uniformly held that the realized increase in value of investments which were sold, were not income but principal. *Boardman v. Mansfield*, 79 Conn. 634; *Parker v. Johnson*, 37 N. J. Eq. 366; *Outcault v. Appleby*, 36 N.J. Eq. 74, 78; *Smith v. Hooper*, 95 Md. 16;

In re Armitage, (1894) 3 Ch. D. 337; *Whitney v. Phoenix*, 4 Redf. 180; *Matter of Gerry*, 103 N.Y. 445; *Neel's Estate* (No. 2), 207 Pa. St. 446; *Slocum v. Ames*, 19 R.I. 401; *Jordan v. Jordan*, 192 Mass. 337.

In *Stratton's Independence v. Howbert*, 231 U.S. 399, this court plainly recognizes that the mere transmutation of property into cash does not result in taxable income. Speaking by Mr. Justice Pitney (pages 414, 415):

> "It is not correct, from either the theoretical or the practical standpoint, to say that a mining corporation is not engaged in business, but is merely occupied in converting its capital assets from one form into another. *The sale outright of a mining property might be fairly described as a mere conversion of the capital from land into money.* But when a company is digging pits, sinking shafts, tunnelling, drifting, stoping, drilling, blasting, and hoisting ores, it is employing capital and labor in transmuting a part of the realty into personalty, and putting it into marketable form. The very process of mining is, in a sense, equivalent in its results to a manufacturing process." (Italics ours.)

In the case at bar there is nothing but a mere conversion of the capital from bonds into money, the court below having expressly found that the defendant in error was in no way engaged in the business of buying and selling securities, beyond occasionally buying for investment and occasionally selling for the purpose of changing the character of his investments. The facts in the case at bar do not materially differ from the facts in *Gray v. Darlington*, 15 Wall. 63. The applicable statute in that case, the Income Tax Law of 1867,

laid a tax "upon the gains, profits, and income of every person . . . whether derived from any kind of property . . . or from any other source whatever." If the realized advance in value of the bonds in *Gray v. Darlington* was income, manifestly it was taxable. If it was income, it was derived during the year when it was realized, as clearly it was not derived before realization. The question of any distinction in meaning between the word "derived" in the Act of 1867 and "received" in the Act of 1916 may be dismissed. The only question is as to the meaning of the word "incomes" in the Sixteenth Amendment, which is only one of the words included in the definition of the subject of tax in the Act of 1867, that is "gains, profits, and income". If the realized advance in value of investments does not come within the definition of income as used in the Act of 1867, it does not come within the meaning of the word as used in the Sixteenth Amendment.

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital." *Gray v. Darlington, supra*, at page 66.

In *Lynch v. Turrish*, 247 U.S. 221, 230, the above passage from the opinion by Mr. Justice Field in *Gray v. Darlington* is quoted, and to the quotation the court adds, "This case has not since been questioned or modified."

It so appears that under the decisions of this court, the sale of an investment realizing an increase in value does not create or result in the derivation or the receipt of income. This, of necessity, follows from the unquestionable proposition that the property in investments are the investments themselves whether the investments be lands, chattels, bonds or stocks.

The decisions in this court are in accord with those in the English and Colonial courts which, without exception, hold that the realized advance in value of investment property is not income taxable under acts which tax income without exception. *Assets Co. Ltd., v. Forbes*, 3 Tax Cases 542, 24 Rettie 578; *Scoble v. Secretary of State for India* (1903) A. C. 299, affirming (1903) 1 K. B. 494; *Californian Copper Syndicate, Ltd., v. Harris*, 5 Tax Cases 159; *Taxation Commissioners v. Mooney* (1907) A. C. 342; *Hudson's Bay Co., Ltd., v. Stevens*, 5 Tax Cases 424; *Trebrau (Johore) Rubber Syndicate, Ltd., v. Farmer*, 5 Tax Cases 658; *Commissioner of Taxes v. Melbourne Trust, Ltd.*, (1914) A. C. 1001; *Mooney v. Commissioners* (1905) 3 Commonwealth Law Rep. 221, affirmed (1907) A. C. 342; *Webb v. Australian Deposit & Mortgage Bank, Ltd.*, (1910), 11 Commonwealth Law Reps. 223; *Bohemians Club v. Acting Federal Commissioner of Taxation* (1918) 24 Commonwealth Law Reps. 334; *McLachlan v. Commissioner of Taxes* (1912) South Australian Law Reps. 138; *Shiels v. Commissioner of Taxes* (1912) South Australian Law Reps. 175; *Commissioner of Taxes v. Booysen's Estate, Ltd.*, So. African Law Reps. (1918) App. Div. 576; *In re the All Red Line, Ltd.*, (British Columbia) Westerly Weekly Reports, 1920, Vol. I, p. 1030.

IV.

CONSTRUED TO TAX AS INCOME ANY PART OF THE PROCEEDS OF THE SALE OF A CAPITAL INVESTMENT, THE INCOME TAX LAW OF 1916, IS TO THAT EXTENT INVALID AS IN CONFLICT WITH ARTICLE I, SECTION 2, CLAUSE 3, AND ARTICLE I, SECTION 9, CLAUSE 4 OF THE CONSTITUTION, BEING A DIRECT TAX ON PROPERTY, AND NOT COMING WITHIN THE PROVISION OF THE SIXTEENTH AMENDMENT.

The scope of the Sixteenth Amendment has been definitely determined by this court.

> "In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income,' as the term is there used; and to apply the distinction as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised." *Eisner v. Macomber*, 252 U. S. 189, 206.
>
> "Thus the genesis and words of the Amendment unite in showing that it does not extend the taxing power to new or excepted subjects, but merely removes all occasion otherwise existing for an apportionment among the States of taxes laid on income, whether derived from

> one source or another. And we have so held in other cases." *Evans v. Gore*, 253 U. S. 245, 261-262.

In order then to preserve the proper force and effect of the clauses in Article I, relative to direct taxation, the Sixteenth Amendment must not be so construed as to permit the direct taxation of property without apportionment, by including in the definition of the word income, realized capital.

> "The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term 'income,' as used in common speech, in order to determine its meaning in the Amendment; and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue." *Eisner v. Macomber, supra*, pages 206–207.

The clear definition of the term "income," as used in common speech at the time of the adoption of the Sixteenth Amendment, certainly did not include any part of the principal value of lands, chattels or investment bonds. The expression "common speech" used by this court does not mean ignorant speech. Furthermore, the amendment was adopted after the meaning of the word income had been well established by the decisions of this court and many state courts which we

have cited, and the decisions of the British courts, uniformly holding that the proceeds of the sale of a capital investment are wholly capital, though sold at an advance over initial cost.

In *Eisner v. Macomber, supra*, in applying the definition adopted in *Stratton's Independence v. Howbert, supra*, and *Doyle v. Mitchell Brothers*, 247 U. S. 179, 185, "income may be defined as the gain derived from capital, from labor, or from both combined," this court added the following explanation (page 207):

> " '*Derived — from — capital*'; — 'the *gain — derived — from — capital*,' etc. Here we have the essential matter; *not* a gain *accruing* to capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value, *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being '*derived*,' that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate use*, benefit and disposal:—*that* is income derived from property. Nothing else answers the description."

In the case at bar the tax was laid upon "a gain accruing to capital," "a growth or increment of value in the investment." There was not a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital. The tax was laid on the capital itself, the exact equivalent in value of the bonds, no part of which were income.

The court states, *Eisner v. Macomber, supra*, page 213:

> "Yet, without selling, the shareholder, unless possessed of other resources, has not the where-

withal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax."

This is equally applicable to the sale of bonds. They are, without question, capital in their entirety before sold; when sold the proceeds do not exceed the value of such capital. If the holder thereof has no other resources, he must, in order to pay the tax, utilize and thereby diminish his capital.

V.

NOTWITHSTANDING THE CONSTRUCTION PLACED THEREON BY THE COMMISSIONER OF INTERNAL REVENUE, THE INCOME TAX LAW OF 1916 DOES NOT PURPORT TO TAX THE PROCEEDS OF THE SALE OF A CAPITAL INVESTMENT OR ANY PART THEREOF AS INCOME.

A tax levied on the entire net income as provided in Section 1 (a) of the Act of 1916, would not apply to any part of the sum received from the sale of an investment, because such sum in its entirety is a realization of capital. If any income were included in such sum it must have been equally included in the property before it was sold. But it is not now open to argument that capital increment is income in the absence of a sale. *Eisner v. Macomber, supra.*

The Government, however, claims that the tax on this increment is justified by Section 2 (a) of the Act of 1916. This section levies no different tax, separate from or in addition to the tax levied in Section 1 (a)

upon "entire net income." It describes but adds nothing to the expression "net income."

Section 2(a) provides that "the net income of a taxable person . . . shall include gains, profits and income derived from . . . trade, commerce or sales or dealings in property." This neither compels nor permits the inclusion of the proceeds of a sale of capital assets, or any part thereof in net income. It can refer only to sales in the usual course of the taxpayer's business, because it is only on such sales that gains, profits or income can be realized.

The sale of a capital asset realizes no more than its capital value. No profit, income, nor gain, can be derived from its sale. The gain derived from increase in value is capital increment, not taxable. That gain, the capital increment, is *not derived from the sale*, and does not come within the Act.

Unless a practical construction by the Treasury Department can effectively enlarge the scope of a statute imposing taxation, there is, in the Act in question, at least a doubt which requires it to be "construed most strongly against the Government, and in favor of the citizen," as held in *Gould v. Gould*, 245 U. S. 151, 153. The construction contended for by the Government, as we have shown, renders the Act invalid in so far as it taxes increase in value of capital investments. As it admits of a contrary and valid construction, the Act should be held not to tax the realization of property values, but only income.

Conclusion.

This case was argued at length, orally and by exhaustive briefs on behalf of both parties, before the

Judge of the District Court, who held the case under advisement and after long and careful consideration filed a comprehensive opinion deciding the case on the constitutional ground in favor of the plaintiff, (the defendant in error here). Under these circumstances, ordinarily, we would feel it due to this court to submit a full discussion of cases cited, and other cases, and an argument of greater length. As certain questions in the case have been presented to the court in other cases recently, and in the brief thereon filed in behalf of the plaintiff in error in the case of *Goodrich v. Edwards*, No. 663, of this term, it seems unnecessary to burden the court with detail which would be, to some extent at least, repetition of the substance of arguments presented in the Goodrich case.

It is respectfully submitted that the judgment of the District Court should be affirmed.

WILLIAM D. GUTHRIE,
HENRY F. PARMELEE,
GEORGE D. WATROUS,
BARRY MOHUN,
Of Counsel for Defendant in Error.

February, 1921.

Office Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1920.

No. 742.

JAMES J. WALSH, UNITED STATES COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF CONNECTICUT,
Plaintiff in Error,

vs.

FREDERICK F. BREWSTER.

WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE DISTRICT OF CONNECTICUT.

APPENDIX TO BRIEF FOR DEFENDANT IN ERROR.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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Extracts from a paper read before the American Economic Association at its thirty-third annual meeting at Atlantic City, December 29, 1920.

by

FRED ROGERS FAIRCHILD,
Professor of Political Economy in Yale University,
entitled,

"FEDERAL TAXATION OF INCOME AND PROFITS."

" * * * A more important and more troublesome problem is that of applying practically the distinc-

tion between income and capital. Income is a service rendered by capital. Increase in the amount or value of capital itself is not income. The distinction between capital and income is not a particularly difficult one in theory. The problems arising from its practical application, on the other hand, are complex in the extreme, and the United States income tax has not succeeded in applying the distinction with any great degree of logic or even of practical success.

On the one hand the distinction is clearly recognized in that gifts and inheritances are regarded not as incomes, but as an acquisition of or an addition to capital. The law expressly recognizes that these additions to capital will themselves in turn yield income which will later be subject to the tax. The law is here in harmony with economic principle.

But suppose capital is increased, not by sudden additions, but by gradual growth in value. Is this increase income? Certainly not, if I have stated correctly the true character of income. This is a question upon which there has been difference of opinion among economists. The issue was fought out at a previous meeting of this Association under the general topic, *Are Savings Income?*[1] I think it is today safe to say that the weight of economic authority supports the theory that mere growth in value of capital is not income. Capital does not render service to its owner by simply growing in size. Presumably it is now capable of yielding a larger service than before, but it is this service which is income, not the increase in the value of the capital. In fact, it is frequently (though not al-

[1] Publications of the American Economics Association, Vol. IX, No. 1, April, 1908.

ways) this very power to yield larger income which has caused the capital to increase in value.

On the whole, the lawmakers have held fairly well to this principle. If land appreciates in value, the increase is not taxed as income so long as the ownership of the land does not change. If a corporation's assets increase in value or its prospects of future earnings improve, the corresponding rise in the value of its shares is not treated as income to the shareholder so long as the ownership remains the same. This is correct. But the situation changes when capital assets are sold or exchanged. In such event the law regards as income the difference between the value of the article on the date when sold or exchanged and its cost, or, if acquired before March 1, 1913, its value on that date. So long as the owner holds his capital its growth in value is generally not regarded as income, but just as soon as he sells it or exchanges it for other property, he must render an accounting, and show a gain or loss; the gain, if any, is income.

This position is clearly illogical, whatever otherwise may be said for it. If growth of capital value is not income so long as the capital is not disposed of, on what grounds can the increase in value be regarded as income simply because a particular piece of capital is exchanged for another of presumably the same value? The transfer presumably makes no change in the value of the owner's capital. No service is rendered to him by his capital on account of the transfer. To treat growth of capital value as income merely because there is an exchange of capital is inconsistent. That such treatment would be likely in certain cases to lead to great injustice is apparently recognized in the law itself, since an exception is made, applying,

however, only to cases where "in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value." In such cases the law prescribes that "no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged." Aside from the reference to "par or face value," which is illogical, this clause of the law represents what I regard as the sound principle to apply to all cases of transfer of capital assets. Why should it be limited to reorganization, merger, and consolidation of corporations? The principle is exactly the same in every case where securities are exchanged for other securities or, indeed, where capital assets of any sort are exchanged for other capital assets. No income is derived on account of the transfer. The presumption is that the value given is the same as the value received, and even if a greater value is received, the result is not income but increase of capital. In this case the gain is of the nature of a gift, and gifts are not regarded as income even in the law.

The matter is perhaps not quite so clear in the case of sales of capital assets. Here the thing received is not another article of capital of the same sort, but money. Yet even here I must confess my inability to find any logical justification for regarding the gain from such sale as income. The owner has simply transferred capital of one form into capital in the form of money. It cannot be said that his capital has yet rendered him a service. It is quite possible that the money will immediately be used in the purchase of

other capital assets of the same general character as those sold. In such case, the owner's capital remains of the same value as before, and it has rendered him no service. But, it may be asked, have we not accepted on practical grounds the legal definition of income as practically money receipts? Should we not say that the owner's capital has rendered him service by bringing in money, and that the money so received is the income? Very good; but if so, it is the entire money proceeds of the sale, not merely the gain, which is income. This would be logical, and there is much to be said for such a construction, if accompanied by the right to offset money expended in the purchase of new capital. To be logical we should either regard the sale of property for money as yielding no income at all, or else we must regard the entire proceeds of the sale as income. I can find no logical ground for regarding as income merely that part of the money proceeds which represents a gain over the cost, or the value on a certain date, of the property sold.

By a somewhat remarkable coincidence, this view has just received support from a decision of Judge Thomas in the United States District Court of Connecticut in the case of Brewster vs. Walsh. The case involved this very point, and the decision, rendered on December 16, 1920, holds "that the appreciation in value of * * * bonds, even though realized by sale, is not income taxable as such." The court concludes that such appreciation is capital, not income, and that a tax imposed upon it is a direct tax and would have to be apportioned among the states according to population. This decision, if sustained, will of course mean a complete reversal of the situation in this respect. Its influence in bringing our income tax law

back to sound fundamental principles will, in my opinion, be second only to that of the decisions of the Supreme Court in the stock dividend cases.

Pending final legal determination of this matter, it may perhaps be a waste of time to discuss a possible compromise. I should, however, like to suggest that, in case this decision should be reversed, the exception which the law now grants for exchange of securities in connection with mergers, etc., should be extended at least to all transfers of property except where there is an actual sale for money or for something so nearly equivalent to money that it can be turned into money without another sale; such, for instance, as a promissory note or a book credit. This I recognize is illogical and a purely practical compromise. But it has the advantage of removing the most serious cases of injustice, and it would simplify greatly the administrative problem.

Of course nothing in the foregoing is intended to interfere with the present practice of determining income of traders and dealers through comparative inventories of stock in trade. There is no reason why this procedure, developed by accounting practice and fairly satisfactory to all concerned, should not continue. Difficulty would occasionally arise in distinguishing a dealer from one who was not in the business of buying and selling goods or capital assets, but this is a matter which could without doubt be taken care of satisfactorily.

While our attention is on the distinction between capital and income, our old friend, the stock dividend, deserves at least a passing word of recognition. I have elsewhere[2] tried to show that, whatever our

[2] Bulletin of the National Tax Association, April, 1918, p. 161; June, 1918, p. 240; April, 1920, p. 208.

theory of growth of capital value, the stock dividend cannot be included in any logical definition of income. It certainly constitutes no service rendered by capital to its owner. It represents nothing given by the corporation to the stockholder. It consists simply in a bookkeeping change in the liability of the corporation to its stockholders; namely, a transfer from surplus to capital. This is not income. But, it may be argued, does not the stock dividend represent a growth in the value of the capital invested in the corporation? Very probably it does, but this growth did not take place suddenly when the stock dividend was paid. The stock dividend did not cause it. It had been going on gradually, for a longer or shorter period, and was shown by the growth in the corporation's surplus. Growth of capital was there already, before the stock dividend was declared, and would have been just as much present if the stock dividend had never been declared. The law must choose one or the other definition. If it choose to define growth of capital as income, it then need pay no attention to the stock dividend, but must periodically ascertain in every case the actual growth in the value of the capital, whether stock dividends have been declared or not. If, on the other hand, the law supports the economic principle that growth of capital is not income, there is no longer even the superficial justification for regarding the stock dividend as income. Fortunately this matter has been definitely settled by decisions of the United States Supreme Court, in a way which agrees I think not only with economic principle, but also with the underlying theory of our income tax law itself.

I recognize that there may be a perfectly reasonable feeling that growth of capital ought to be taxed.

But this is an entirely separate question from whether growth of capital should be treated as income. The fact that inheritances are not subject to the income tax does not mean that we cannot tax inheritances. If growth of capital assets is a proper subject for taxation, there should be a separate tax for that purpose. Such taxes have already been developed in various countries; for example, Germany's *Zuwachssteuer*, which before the war had made considerable progress. Of course, the fact is that such a tax would undoubtedly be considered a direct tax in this country and would so run counter to the constitutional requirement of apportionment among the states according to population. This is a legal rather than an economic obstacle, and in my opinion does not justify a strained definition of income in order to evade the constitutional limitation upon direct taxation. The proper remedy is a constitutional amendment. States and municipalities of course are subject to no such restriction. * * *"

REMARKS OF PROFESSOR FAIRCHILD IN CONCLUDING THE DISCUSSION OF THE FEDERAL TAXATION OF INCOME AND PROFITS.

"The discussion this morning has brought out one conflict of opinion which is fundamental. This has to do with the theoretical definition of income and the distinction between income and capital. It was not my intention in this paper to bring up again any lengthy discussion of this old question. As I have already stated, this is a point upon which there has been difference of opinion among economists, and although

the matter was discussed at length at the annual meeting of this Association in 1908, it is not surprising to find that difference still persists. I was not myself present at that meeting, but my reading of its proceedings has led me to the impression that the advocates of the definition of income which I have used this morning had decidedly the better of the argument, and I am still of that opinion. For the purpose of the problem before us today we must simply recognize that a difference of opinion exists among economists as to the theoretical definition of income.

Now when we come to the practical problem before us this morning—namely, how to carry over into the field of the income tax our economic concept of income, it should of course be obvious to everyone that no theoretical concept can be applied exactly without numerous inconsistencies and difficulties, necessitating as a practical matter many qualifications and adjustments. This result will come no matter what theoretical definition we take as the starting point. That definition will be most useful in the practical problem which in the long run causes the least of such difficulties and necessitates the fewest adjustments. From this standpoint I am decidedly of the opinion that the definition of income which I have used has the distinct advantage over that definition which would include increases in capital value as income.

Professor Haig in particular has pointed out difficulties which would follow the application of my definition. In this he has been generous. He might easily have added to his list. In my study of this matter the difficulties which he mentions and many others have been foreseen. They may be generally overcome without meeting any insuperable obstacle.

But suppose we turn to the definition which he proposes. We are then immediately confronted with an overwhelming swarm of difficulties, to a very few of which I should like to call attention.

First—Gifts and inheritances should logically be included in income, with practical results which are not pleasing to contemplate.

Second—Capital frequently increases in value merely on account of the depreciation of the currency standard. To consider such increase as income is fundamentally unjust and, in extreme cases, ruinous. Complaints and petitions for relief have come in great volume from the business world on account of the injustice done from counting as income appreciation in value of assets, even in cases of annual inventories, where the matter is far less serious than when it has to do with relieving permanent capital assets. Professor Haig has suggested that this difficulty is to be met by the application of an index number correction. Others have thrown doubt upon the usefulness of this device. Personally I hope the time may come when we shall have devised some arrangement to correct the fluctuations of our monetary standard, but at best this is in the more or less distant future. What we are considering today is a present practical problem.

Third—To bring out clearly the simple principle, take A who owns a forest whose value on account of the growth of the timber is increasing at the rate of a thousand dollars a year. B receives an income of a thousand dollars a year from salary, interest or dividends. According to Professor Haig's definition of income, these two men are in the same situation and should be taxed alike. The fact is, they are not at all

in the same situation. A, during the time his forest is growing to merchantable size, receives no service from it. It yields no income, yet he is compelled to pay an annual tax, to meet which his capital furnishes him no funds. Suppose after twenty years, before any timber is cut, the forest is destroyed by fire. A has received no income under my definition. He has certainly realized nothing from the forest, and his position is the "reductio ad absurdum" of that definition which includes as income increase in value of capital assets. It is true that he could now be allowed to deduct his loss, but this he can only do to the extent to which he has income from other sources from which to make the deduction. He is granted no return of the tax paid in respect to income never received. This is an extreme case. But other cases of injustice differ from it only in degree, on account of the shorter term for which the investment runs before yielding a return. Treating as income the gain from sales of more or less long time investment has produced innumerable cases of injustice under the present law. * * *"

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PETITION FOR REHEARING.

HENRY F. PARMELEE,
GEORGE D. WATROUS,
HENRY M. WARD,
BARRY MOHUN,
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PETITION FOR REHEARING

Frederick F. Brewster, the defendant in error, by his counsel, prays for a rehearing of the above entitled cause.

The instant case, and the cases of *Merchant's Loan & Trust Company v. Smietanka*, No. 608, and *Eldorado Coal & Mining Company v. Mager*, No. 609, argued January 11th and 12th, and *Goodrich v. Edwards*, No. 663, argued with the instant case March 11th and 12th, were all decided on the same day, March 28th. The principal opinion was written in the *Merchant's Loan & Trust Company* case. All the questions involved were thereby decided in favor of the Government, with the exception of the question involved in the instant case and in the Goodrich case, namely as to whether when no profit has been realized, or a loss has been in fact sustained, upon the sale of property acquired before March 1, 1913, the Act of 1916 imposes a tax upon the difference between the market value on that date (it being lower than the value at the time of acquisition) and the price realized upon the sale. This question has been decided in favor of the taxpayers.

The defendant in error respectfully represents that a rehearing should be granted for the following reasons:

In the instant case counsel relied on the concession made by the Solicitor General in his brief in the *Merchant's Loan & Trust Company* case (p. 28) based on the ruling of this Court in *Lynch v. Turrish*, to the effect that under the Act of 1913 (38 Stat. 166) realized increment of value was not taxed. This concession was apparently overlooked by the Court for in the opinion in the *Merchant's Loan & Trust Company* case (p. 5) it is stated:

> "There can be no doubt that the word (income) must be given the same meaning and content in the Income Tax Acts of 1916 and 1917 that it had in the Act of 1913."

The concession of the Solicitor General referred to is as follows:

> "In *Lynch v. Turrish* the Act of 1913 was involved. That Act was unlike the Act of 1909 and like the Act of 1867 in that it imposed the tax upon the income *arising or accruing* during the year. The distinction drawn in the *Doyle* case, therefore, did not apply to the *Turrish* case, and *Gray v. Darlington* could very well be treated as authority in the latter case. In the Act of 1916, however, the language of the Act of 1913 is abandoned and Congress goes back to the Act of 1909 by imposing the tax on income received during the year."

In the brief of the Solicitor General in *Goodrich v. Edwards* submitted in the instant case as well, this concession is repeated as follows (p. 6):

"*Gray v. Darlington* (15 Wall. 63) is not applicable to the present controversy. This court held in *Hays v. Gauley Mountain Coal Co.* (247 U. S. 189) that it was not controlling in a case arising under the Act of 1909 because that act measured the tax by the income *received* during the taxable year. True in *Lynch v. Turrish* (247 U. S. 221), it was said that *Gray v. Darlington could not be distinguished from a case arising under the Act of* 1913 which levied a tax upon income *arising or accruing* during the taxable year. The present act, however, goes back to the language of the Act of 1909 and imposes the tax upon income received during the taxable year."

It is submitted that *Lynch v. Turrish* (247 U. S. 221) is a controlling authority upon the proposition that the construction of the Act of 1913 is identical with that of the Act of 1867 upon the point involved, namely, that realized increment of value is not income or included within the term "gains, profits and income derived from any source whatever", a term common to both the Act of 1867 and the Act of 1913.

Yet the Court in its opinion in *Merchant's Loan & Trust Company v. Smietanka*, says, at page 3:

"Plainly the gain we are considering was derived from the sale of personal property and very certainly the comprehensive last clause, 'gains, profits and income derived from any source whatever', must also include it, if the trustee was a 'taxable person' within the meaning of the Act when the assessment was made."

In both *Lynch v. Turrish* and *Lynch v. Hornby* (247 U. S. 339), the increment of value had accrued to the corporation prior to March 1, 1913. In both cases the cash dividend which was the subject matter of the tax imposed, was received by the stockholder after that date. In the *Turrish* case what the taxpayer received was a final dividend upon the liquidation of the corporation. Upon the authority of *Gray v. Darlington* this final dividend, though it clearly was a gain or profit (p. 228), was held to be "increase of capital and not subject to a tax as income". In the *Hornby* case the dividend was paid in the ordinary course of business and was held to be income and taxed under the Act of 1913, although it represented an increment of value accrued prior to "the time of the law" (247 U. S. 229).

Had the capital profit involved in the *Turrish* case been income or been included within the content of the term "gains, profits and income derived from any source whatever" it must under *Lynch v. Hornby* and *Brushaber v. Union Pacific Ry. Co.*, have been taxed under the Act of 1913.

In *Lynch v. Hornby* there was no growth or increment of value after March 1, 1913, but all before that date. The cash dividend based on such increment of value was paid by a going corporation and was, therefore, income in the well understood and established meaning of the word. In *Lynch v. Turrish* the stockholder received a final dividend in liquidation which was held not taxable under the terms of the Act of 1913 because on the authority of *Gray v. Darlington* it was capital and not income.

It is further submitted that while under the departmental practice for some years income tax has been

imposed with respect to realized increment of value, this construction of the Act of 1913 was held by this court in the year 1918 (*Lynch v. Turrish*) to have been erroneous; that a similar construction of the Act of 1867 amending the Act of 1864 was held by this court in the year 1872 to have been erroneous (*Gray v. Darlington*); that no similar question had arisen or could have arisen with respect to the Act of 1894 at the time that Pollock brought his suit to enjoin the Farmers' Loan and Trust Company from paying income tax upon rents from real estate and interest and dividends from securities, that Turrish raised the point in 1914 (247 U. S. at 222) and finally that the plaintiff in error in the instant case raised the point before the Commissioner in 1917, when he made his return and that he has prosecuted this contention and asserted his claim of constitutional right with the greatest diligence and utmost expedition.

It is submitted there is no authority for the proposition that weight is to be given to an administrative construction of an act in direct conflict with the judicial construction given to the same language in a prior act, and that even before the enactment of the Act of 1916 the very point here involved had been raised by Turrish with respect to the construction of the Act of 1913.

It is further submitted that the British income tax decisions were cited, not as authorities upon the construction of the terms of the Act of 1916 but as showing a long and well established judicial definition of the word "income" as exclusive of capital, and a continuous ruling that realized increment of value is intrinsically capital, not income, hence as bearing upon the meaning of the word income when used in the Sixteenth Amendment (the meaning of which cannot be extended by

Statutory Enactment) as well as in the income tax laws. In like manner the decisions of all the highest courts of all the states which have passed upon the point, holding that profits realized upon the sale of investments of trust funds are capital, not income, were cited, not as relevant to the terms of the Act of 1916, but as showing beyond all controversy that from 1909 when the Amendment was proposed until 1913, when it was adopted, there was complete unanimity of judicial decision in holding that realized increment of value is capital, not income. In these cases there are not various rules adopted in various jurisdictions (as there are with respect to stock dividends) but one universal rule of decision holding realized increment of value to be capital.

Moreover in the cases on life tenant and remainderman, as in *Gray v. Darlington* and *Lynch v. Turrish*, and as in all the British income tax cases, the question involved was as to whether realized increment of value is inherently income or capital, just as in *Gibbons v. Mahon*, *Towne v. Eisner* and *Eisner v. Macomber* it was whether a stock dividend is the one or the other.

It is submitted that a construction of the word "income" as used in an income tax law adopted by this court for the first time in 1920 and never adopted by any court, before the proposal and adoption of the Sixteenth Amendment, or the enactment of the Act of 1916, cannot properly be said, in view of the unanimous rulings to the contrary, to define the meaning of the word in common usage at the time the Amendment was proposed and adopted.

It is submitted that all the cases arising under the Corporation Excise Tax Act of 1909 involved business

transactions, sales which were made through the exercise of the privilege of doing business in corporate form, upon which privilege the tax was imposed; that "income" as has been repeatedly pointed out did not necessarily have the same meaning in that act as in the amendment or in an income tax law. The decision in the case at bar, read in connection with *Lynch v. Hornby*, gives to Congress the power to tax at a graduated rate as income in the year of realization by sale, the increment of value in capital investments however long the period of accrual. The limitation of the period of accrual, so as not to antedate March 1, 1913, is a mere act of grace on the part of the legislature, and now in 1921 the accrual period has grown to eight years. It might as well be fifty years or a century.

It is submitted that there is a clear and fundamental distinction between profits realized from the sale of property in the course of business and the increment of value in property held as an investment of capital, realized through the sale of such property. The distinction relied on does not depend, as has been intimated in the opinion (page 6), on

> "whether the sale or conversion be a single isolated transaction or one of many"

but on whether the transaction is in the course of business or trade on the one hand or is a conversion of capital on the other. Though there be but one transaction, if it be a sale in the course of business, the profit will be income, conversely there may be a series of transactions each constituting a sale or conversion of capital assets, where no income will accrue but the entire proceeds will be capital.

The true distinction, it is submitted, is that realized increment is inherently capital, not taxable as income, where it is the result of a gradual growth or appreciation of value in the property itself, entirely apart from, and independent of, any act of the owner with respect to such property, or, to express the same thought in a concise phrase, where it is "unearned increment." On the other hand, a gain, or profit, realized from the sale or conversion of property, is inherently income where the owner or seller of the property has himself, through his acts with respect to the property, his mental and physical efforts and work, brought about the result of selling the property at more than he paid for it, but where the increment in value in the property itself, if any, is not an essential or controlling element in determining the fact of the realization of a profit. In the one case the gradual increment of value is, generally speaking, the sole cause in the realization of a "profit". In the other, increment of value is, in most instances, if not in all, merely incidental, but one partly contributing element, and an element of minor importance, in determining whether, on the whole, the business, trade, or speculation, shows a profit or a loss. In the case of a sale in the course of business a net profit, constituting an item of taxable income, may, and indeed generally does, arise even where there has been no increment of value in the property itself, considered apart from the value of the work that has been done with respect to it. The inherent value of the property itself considered apart from the work that has been done with respect to it may even be less at the time of sale than at the time of acquisition, yet, by reason of the work done, a business profit may be realized.

It is further submitted that there should be no apprehension that the construction of the Amendment and of the law advocated "would in a large measure defeat the purpose of the Amendment". (Opinion p. 7.)

The object and scope of the Amendment have been clearly defined. The contention has been earnestly pressed that the words "from whatever source derived" empowered Congress to tax the salaries of the Federal judges and of the President and of officers of the States. This construction has been definitely and finally rejected. (*Brushaber v. Union Pacific Ry. Co.*, 240 U. S. 1; *Evans v. Gore*, 253 U. S. 245; *Eisner v. Macomber*, 252 U. S. 189.)

Rents from real estate and income from invested property were not capital before the Amendment and income after its adoption. The Pollock case held that in substance and effect a tax on such rents and income was a tax upon the capital from which they were derived. The effect of the Amendment is not to transmute what before was capital into income, but to forbid an inquiry into the source of the income. Capital must still be taxed by the rule of apportionment, and the use of the word "incomes" rather than the term "gains, profits and income" indicates beyond controversy that no extension of the meaning and content of the word income was intended.

The distinction is the same as that between the capital assets of a corporation and its stock in trade. A corporation upon a profitable sale of its capital assets does not increase its earnings or income nor conversely upon the profitable sale of its stock in trade does it increase its capital assets. The distinction is perhaps

more emphatic in the case of a corporation for the law requires a separation between the capital and earnings of a corporation. But the same principle applies equally to individuals; the investments of an individual are his capital.

It is further submitted that the Court may have overlooked the debates in Congress at the time that the Sixteenth Amendment was proposed and at the times when the Acts of 1913, 1916 and 1919 were before the Senate and House of Representatives. The debates upon the amendment are referred to in the brief filed by Senators Smith and Gore as *amici curiae* (pages 12, 15, 16, 24 and 30.) The debates on the Acts of 1913 and 1916 are quoted in the appendix to the brief in *Goodrich v. Edwards*, No. 663. These debates clearly show that it was not the intention of Congress, either in the Amendment or any one of these Acts, to include realized capital increment as an item of taxable income.

For the reasons above stated the request for a re-argument is respectfully submitted.

HENRY F. PARMELEE,
GEORGE D. WATROUS,
HENRY M. WARD,
BARRY MOHUN,
Of counsel for Defendant in Error.

We hereby certify that in our opinion the above petition is well founded.
Henry F. Parmelee.
George D. Watrous.
Henry M. Ward.
Barry Mohun.

FILED
MAR 10 1921
JAMES D. MAHER,
CLERK

IN THE

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1920.

No. 742.

JAMES J. WALSH, COLLECTOR OF INTERNAL REVENUE, PLAINTIFF IN ERROR,

against

FREDERICK F. BREWSTER.

BRIEF AS AMICUS CURIAE FOR C. J. HEPPE & SON.

H. EDGAR BARNES,
Counsel for C. J. Heppe & Son.

(NOTE.—The following discussion was published in essay form, and by reason of its analysis of the questions now before this court in the entitled case, it was suggested to its author that it be filed with the court as a brief *amicus curiæ*.)

Is Capital Income?

Does the Power of Taxation to Destroy Extend to the Destruction of Constitutional Guarantees?

By

GEORGE H. EARLE, JR.

OF THE

PHILADELPHIA BAR

Philadelphia

1921

Preface

"In this consists freedom, viz., in our being able to act "or not to act as we shall choose or will."

—Locke, H. U. II, XXIX, 27.

Full inquiry, it is believed, will prove that, had it not been for the constant and faithful vigil that the Supreme Court has maintained, in the performance of its highest function—the preservation of our Liberty —the United States during the past decade would have become, at least economically, as communistic as Russia itself, with all the accompanying evils involved.

Nothing could be more unfortunate than the growing tendency of the Government during that period to meet every difficulty, no matter how temporary or self-remedying, by legislation, which, if sustained, would nullify permanently the most vital of those Constitutional rights, of which the Supreme Court continues the ever faithful and sworn defender.

It would serve no purpose to discuss at this point the multiplicity of instances proving this assertion. It is sufficient for the present to point out that on a single recent day, Articles IV, V and VI of the Constitutional Amendments would have been in great part nullified, but for the Court's faithful and patriotic performance of its duty. And this blow at our freedom would have met the approval of ignorant critics who happily have not failed to have their absurdities exposed. A leading and most able journal recently said: "What is unfortunate is that ignorant, "thoughtless, reckless lawmakers rode at a hard gallop "through the Constitution of the United States, so in-"capable of doing what needed to be done, so heedless

"of whither they were headed, that a unanimous Su-
"preme Court, Conservatives, Liberals, and Radicals
"all together, condemn their performance as illegal
"and insufferable. * * * The invalid sections of the
"Lever Act, in short, made a hash among other things
"of the guarantees of the Constitution of the United
"States * * *. **Judge and Jury could become Constitu-
"tion, Statute Law, judicial process, economic ruler, ar-
"biter of destiny—everything. The only unfortunate thing
"about the Supreme Court's decision, in truth, is that it
"had to be because the crazy Lever Act was."**

There could be no more absurd error than concluding from the fact the jackasses bray so loudly that they represent the enduring convictions of the American people, as to the paramount necessity of preserving their Liberty. Communism seems all embracing, until it is put to the test of an election, or trial before a jury upon an indictment—when it becomes less than the shadow of a shade.

And the "Lever Act was" simply the result of a disregard of the instruction perfectly available and to be found in the history of the economic, the common, and our constitutional law. In a recent Essay, "Does Price-Fixing Destroy Liberty?", the writer discussed the subject of governmental interferences with the Liberty of Trade as affected by the Lever Act. The present inquiry considers the dangers to our Freedom involved in the attempts being made, not by Constitutional Amendment, but by claims of amplifying construction to **nullify** further the provisions of **Article I, Section 2, Clause 3; and Article I, Section 9, Clause 4, of the Constitution as originally drafted**, relating to direct taxation.

The attempt has been made in the Essay above

mentioned—"Does Price-Fixing Destroy Liberty?"—to show how vital a preservation of Liberty is to the happiness of America, a summary of the subject is therefore only necessary.

Locke's definition, as quoted above, is, of course, generally correct, but, as it is essential to Justice that all men should be safeguarded in an **equal** enjoyment of this most vital thing, his definition, for Constitutional purposes, must be so far restricted as the common welfare requires in this respect. But, as the Common Law always points out, the primary presumption is **always in favor of the greatest Liberty possible, which is simply saying the same thing in another form, for if Liberty be confined to but a few, it is necessarily greatly restricted**; and the burden of proof is always upon those contending for restriction, and restriction of Liberty is always **prima facie** bad. We must, too, never forget that as Thomas Jefferson and other great statesmen have truthfully stated: "**The natural order of things is "for Liberty to yield and for Government to gain ground.**" And all History but testifies that this **has been** the chief danger, the most ominous threat, not merely to Governments, but to civilization itself.

Restrictions, therefore, introduced into the Constitution to safeguard against this tendency, are deserving of the highest respect and most vigilant care. It will be found that great attention has been heretofore given by Jurists to the "**genesis**" of the Sixteenth Amendment, which, no doubt, is important; but what to the writer seems even more important, is that so far as he has ascertained, **no proper inquiry has yet been made**, as to the "**genesis**" of the two clauses in the Constitution in part amended by it. The purpose of this article is, therefore, to inquire, using the methods

prescribed by the Supreme Court, as to the exact meaning of the original Constitution, the purpose for which it was introduced, and the dangers to Liberty which it was intended to remove. As Mr. Justice Holmes has clearly in such matters pointed out, economics and statesmanship are proper aids in reaching proper solution, a word upon these subjects may not be without value. It is universally acknowledged that all restraints upon trade ("which the law so abhors") are prima facie bad. Such restraints have been demonstrated for centuries to curtail trade. Freedom is the prime requisite for enlarged production, while servitude its surest restraint. It most certainly follows that provisions which inhibit men from transfering capital from one capital use to another, as the exigencies of business may require, leaving, of course, the enlargement of income that thus becomes available for Governmental purposes, must strongly tend not only to impoverishment of the community, but to the depletion of Governmental resources. No man of large business activity can honestly fail to testify to innumerable cases where both the National wealth and the Government's revenue have suffered from this very cause. A merely superficial inquiry would disclose endless beneficial transactions, that have been precluded by the fear that these necessary and productive shifts of Capital, (because of the pretense that they in some mysterious way changed in to "Income"), might thus result in its confiscation. Admittedly Capital is one of the prime necessities of employment and production, without which neither the people or the Government can thrive. Necessarily business is restrained from following its natural and productive bent, by, in effect, penalizing it for continuing its free course as determined by business requirements. This is greatly accentuated by

the condition of our currency. A single illustration may suffice—and there are multitudes of such cases. Assume that a man has invested his capital in a certain business or productive property: The Government, then, so inflates its currency that he must get, and can get, two dollars (now worth really fifty cents apiece), in the place of the one hundred cent dollar which before really measured the value of his property. A change of investment becomes desirable from all points of view; but he cannot make it, if, perhaps, half of his capital investment can be wrested from him, so that he can only replace his present capital investment with one of half the productive and real value. Such a Government policy, as is pointed out in the Boyd Case, 116 U. S. 616, is the exact equivalent of positive prohibition. This indeed, would certainly create a new and most vicious "law of diminishing returns." That the mere threat has, and is doing an enormous amount toward creating the present distressing state of employment and business, will be testified to by any intelligent man largely familiar with business; that it will, hereafter, tend even more largely to deplete, instead of increase, the revenues of the Government, as return from inflation to deflation, must be plain to any man making any pretensions to statesmanship; that it is a dangerous invasion of the Liberty and independence of America, that the Constitution was chiefly intended to preserve, will, it is hoped, be made clear in what is now to follow.

Is Capital Income?

Does the Power of Taxation to Destroy Extend to the Destruction of Constitutional Guarantees?

CHAPTER I.

The Meaning and Genesis of the Clauses in the Constitution Relating to Direct Taxation.

"At times Judges need for their work the training of "economists and statesmen, and must act in view "of their foresight of consequences."

—Mr. Justice Holmes, Northern Securities case, 193 U. S., page 401.

Is Capital Income? A foolish question? A vital one, for if the Fathers be right, upon its correct solution, may depend both the continuance of our essential liberties and of free government.

To ascertain the truth of this, one has but to understand and follow the guidance to be procured from a correct comprehension of the inspired quotation made above, as it, if understood, points to the fundamental distinction between our Supreme Court and those of all other countries. The duty of other Courts is not to make, but to declare the law already established. As to them, it might properly be asked: What theories of economics or statesmanship have to do with the performance of their function?

But the Supreme Court is not an **ordinary** Court. On the contrary, as the greatest creation of the Fathers, it has a far higher and nobler purpose,—that is, **the preservation of American Liberty**; the Justices constitute **the sworn guardians of the last defense of Free-**

dom; and as their high function, necessarily, requires knowledge of economics and statesmanship, these become the very vitals of proper solution, **where Liberty is in question.** And Liberty is always in question, where a taking of property **without consent** is involved. Indeed, all the Anglo-America Civil Wars have turned chiefly upon this paramount matter; for it must not be forgotten that the same principle which underlies these taxes is involved in the decisions relating to restraints of trade and monopolies. Monopolies have always been denounced as "odious" and "pernicious," because they create a power of taxation **without consent**, whether it be for the benefit of such governments as the Tudors and Stuarts attempted to erect,—or, what is even worse, that of private individuals seeking to this extent to enslave their fellows. The seed thus sown by Mr. Justice Holmes, therefore, inevitably grew into the great inquiry made by the united Court in the Standard Oil case, 221 U. S. 1, a decision that, at last, has brought satisfactory solution of the general principle, without a knowledge of which the necessary degree of clarity and certainty continued lacking.

To very much the same effect is Mr. Justice White's opinion in the Knowlton case, 178 U. S., at page 57—one of the decisions, also that helps to a correct understanding and proper definition to be gained from the discussions of those taking part in the formation of the original Constitution. He said: "The "necessities which gave birth to the Constitution, the "controversies which preceded its formation, and the "conflicts of opinion which were settled by its adop- "tion, may properly be taken into view for the pur- "pose of tracing to its source any particular provision "of the Constitution, in order thereby to be enabled to "correctly interpret its meaning."

To the many similar authorities may be added a single quotation from Mr. Justice Pitney's decision in the Eisner case, 252 U. S. 189: "A proper regard for "its genesis, as well as its very clear language, requires "also that this amendment" (the XVI) "shall not be "extended by loose construction, so as to repeal or "modify, **except as applied to income**, those provisions of "the Constitution that require an apportionment ac- "cording to population for direct taxes upon prop- "erty, real and personal. **This limitation still has an ap- "propriate and important function, and is not to be over- "ridden by Congress or disregarded by the Courts.**" But, of course, it is imperative that the original provision, that thus still stands in full force and effect, **and the reasons for it**, be understood, if it is to be given its fully intended effect; and it is from the fact that, so far as the writer has discovered, this most vital viewpoint has nowhere, as yet, been even presented to the Courts, that this present Essay has been undertaken.

This is all the more surprising, if it be but remembered how constantly and repeatedly the Supreme Court has instructed us as to the proper and necessary method for the correct interpretation of the Constitution and its Amendments.

In the first place, the meaning of the Constitution **never varies.** It means today exactly what it meant on the day of its adoption. To hold otherwise would destroy the judicial character of the Supreme Court, and make the continuance of our "unalienable" rights completely uncertain. This has been forcibly stated in South Carolina vs. United States, 199 U. S., at 448: "The Constitution is a written instrument. **As such its "meaning does not alter.** That which it meant when "adopted it means now. * * * Those things which

"are within its grants of power, when made, are still "within them, **and those things not within remain still "excluded.** * * * Any other rule of construction, "**would abrogate the judicial character of this Court, and "make it the mere reflex of the popular opinion or passion "of the day.**"

The proper test is never merely to ask what we might guess the meaning **now**; but what was their meaning **then?** What the drafters of the Constitution would say of the interpretation asked? If the Court can say that the makers of the Constitution would not give the interpretation contended for, that, "they never would have approved of them," that: "The struggle against "arbitrary power, in which they had been engaged for "more than twenty years, would have been too deeply "engrafted on their memories to have allowed them to "approve of such insidious disguises of the old griev- "ances, which they had so deeply abhorred," the interpretation becomes impossible. Boyd vs. United States, 116 U. S., at page 630.

And "to determine the extent of the grant of "power **we must** * * * **place ourselves in the position of "the men who framed and adopted our Constitution, and "inquire what they must have understood to be the mean- "ing and the scope of those grants.**" South Carolina case, 199 U. S., at page 450.

"It must be interpreted in the light of the Com- "mon Law, **the principles and history of which were "familiarly known to the framers of the Constitution.**" Wong King case, 169 U. S., at page 654.

"The language of the Constitution, as has been "well said, **could not be understood without reference to "the Common Law.**" This principle is firmly established in the South Carolina case, 199 U. S. 450; the Minor

case, 21 Wall. 162; the Watson case, 114 U. S. 422, and in the Moore case, 91 U. S. 274, &c.

"The interpretation of the Constitution * * * "is necessarily influenced by the fact that its provisions "are framed in the language of the English Common "Law, **and are to be read in the light of its history.**" Smith vs. Alabama, 124 U. S. 478.

Why these unerring methods have not been heretofore fully applied is a strange enigma of this subject, especially as it is believed that they inevitably lead to correct solution of all the questions that have arisen or that may arise. It is passing strange that the meaning and genesis of the Sixteenth Amendment should have been sought, whilst those of the **two** provisions of the Constitution, in part amended by it have so far as ascertained, been no part of the inquiry.

But before making these essential inquiries, directed by the Supreme Court, a matter leading to much confusion of thought should first be disposed of. By some it has been earnestly contended that **all** amendments must be liberally interpreted. But it is believed, that there is no ground for such contention. Of course, on a very general principle, statutes are naturally to be construed if possible to be effective, not ineffective, and, therefore, where a power is constitutionally granted, the implied powers necessary to make the grant effective go with it. But that has nothing to do with the question as to what power has actually been granted. If a power be given to tax beans, that which is necessary to tax beans is certainly granted. No one denies that. But this does not, in the slightest degree, create a right to tax peas, though there be similarities, nor any implied powers necessary to do so. The rules of construction as to acts that, in effect, penalize or

burden citizens, as will be demonstrated, are of a directly opposite nature; and the fact that when a power is effectively given, it is to be so construed as to make it effective, has no bearing whatever on the primary question as to whether it exists at all.

The distinction is perfectly obvious, and has always been regarded by the Courts, as covering a vital part of our Liberty. Broom thus clearly states: "A "remedial statute, therefore, shall be liberally con- "strued so as to include cases which are within the "mischief which the statute was intended to remedy, "whilst, on the other hand, where the intention of the "Legislature is doubtful, the inclination of the Court **"will always be against that construction which imposes "a burden, tax or duty on the subject.** It has been desig- "nated **'a great rule'** in fiscal laws that they are not to "be extended by **any labored construction, but that you "must adhere to the strict rule of interpretation.**" The general rule is merely an application of the familiar maxim "*ut res magis valeat quam pereat*"; but to contend that because where the "*res*" is clearly declared, it is to avail, it follows that because it is to avail, there is conclusive proof that it has been created, merits no further refutation than a mere statement of the proposition itself. By such a method, any absurdity can be irrefutably demonstrated.

The main inquiry relating to the history, the Common Law, the economics and statemenship of the matter, may now be further followed.

All Americans will remember the conflict between Lord Mansfield and Lord Chatham upon this very question. Mansfield's argument, being supported by the King, and enforced against America, caused disruption of the British Empire, which would have been

prevented had the eloquent pleas and admonition of Lord Chatham been followed; and, later, this very policy of liberal treatment having been applied to Canada and Australia, taught the lesson of splendid sacrifices which will be made by freemen, treated as freemen ever should be. Who is not, even at this day, thrilled by Lord Chatham's inspiring language, that so entirely accords with the principles of Chief Justice White and Mr. Justice Holmes, already adverted to: "I come not "here armed at all points, with law cases and Acts of "Parliament, with the statute book doubled down in "dog's ears, **to defend the cause of Liberty**. But * * * "for the defense of **Liberty, upon a general principle, "upon a Constitutional principle, it is a ground on which I "stand firm—on which I dare meet any man.**"

To a man forgetting what the genesis of the Supreme Court was, what mighty purpose of its creation was, it might appear that Mansfield was right. But to one remembering that Liberty was protected by the Constitution of Great Britain; that we are living under the dispensation of the Common Law defended by Chatham, not the technical servitude of Mansfield; that by our Constitution the Supreme Court has a higher office than that of mere judicial action; that it is, in fact, made by the Constitution the **sworn and last defense of Freedom**, the real value of the thought of Mr. Justice Holmes, as expressed in the Northern Securities case, and amplified by the Chief Justice in the Standard Oil case, compels its due appreciation.

We are thus brought to the vital inquiry: What, then, is the "genesis" of the important clauses of Article I, Section 2, Clause 3, and Article I, Section 9, Clause 4, of the Constitution? What was it that led the Founders **unanimously** to insist upon the adoption of these clauses as part of the Constitution?

No one will deny that the Founders' ideals of Liberty were clear and definite; that they were based upon upward of seven centuries of unvarying experience of themselves or their ancestors; nor the earnestness of their desire that the benefits of so many years of labor and sacrifice should surely accrue to the advantage of their and our posterity.

And, yet without the full inquiry imperatively demanded, questions are now being determined in relation to attempted modification of Constitutional safeguards, which the Fathers, out of their greater knowledge and unsurpassable judgment, felt absolutely necessary for the preservation of our freedom and happiness.

What was that Liberty that they were so striving to protect; the compelling reasons for the provisions actually adopted? How far, and if at all, can the Sixteenth Amendment be construed to depart from and nullify the underlying principles of the provisions which these patriotic masters of political science so carefully ordained? Can there be more important inquiry?

It were too long to recite Magna Charta, with its multiple provisions. The able summary of Henry Hallam succinctly serves the purpose. He says "It is "still the keystone of English liberty. All that has "since been obtained is little more than as confirmation "and commentary. * * * **The essential clauses of "Magna Charta are those which protect the personal liberty and property of all freemen, by giving security from "arbitrary imprisonment and arbitrary spoliation.**" And then, after quoting, he continues: "It is obvious that "these words, interpreted by any honest court of law, "convey an ample security for the two main rights of "civil society."

Magna Charta, after frequent confirmations, was questioned under the Tudors and Stuarts, but at last was definitely established by the "Petition of Rights" in 1628. This latter constitutional document, after quoting the fundamental Statute (of Edward I) de Tallagio, &c., "that no tallage or aid shall be laid or "levied by the King * * * **without the good will and "assent of * * * the freemen of the commonalty of this "realm,"** finally reasserts these fundamental rights.

In the Grand Remonstrance of 1641, we find additional protest against **"monopolies and other unlawful taxes."**

But Charles I died on the scaffold because he was unable to learn that there was one form of Liberty that the Anglo-Saxon peoples would never be deprived of, that is the right to be secure in their property, and free to grant or withhold their **consent** to being deprived of it.

There can be no greater justification of the care with which our forefathers fortified us against similar danger than the fact that Englishmen, having thus safeguarded their own freedom, having thus not merely fought for, but died for the principle involved, could, in less than a century, themselves attempt, by similar method, to destroy that of their fellow-subjects, living **at a distance**, in the Colonies, even though of identical blood and tradition; not, however, without vigorous protest from their own greatest men who really understood how important and of what Liberty consisted.

Lord Chatham immortalized himself by proclaiming to them in Parliament that they were dealing with "a subject of greater importance than ever engaged "the attention of this House, that subject only ex-"cepted, when, near a century ago, **it was a question of**

"whether you yourselves were to be bond or free." That "the Americans are the sons, not the bastards, of England." That "the taxes are a voluntary gift and grant. "* * * The Commons of America * * * have "ever been in the possession of this right, their Consti- "tutional right, of giving and granting their own money. "They would have been slaves if they had not enjoyed it."

But could there, now, be a greater absurdity than the contention that a Revolution, undertaken in support of this right, declared constitutional by Pitt, even before the adoption of our Constitution, had, in some mysterious way, been lost by their success in defending it?

That Pitt spoke correctly can be evidenced almost beyond limit. Thus Edmund Burke again told Parliament: "The people of the Colonies are descendants of "Englishmen. England, sir, is a nation which, still, I "hope, respects, and formerly adored her freedom. The "Colonists emigrated from you when this part of your "character was most prédominant. * * * They are, "therefore, not only devoted to Liberty, but to Liberty "according to English ideas * * *. It happened, as "you know, sir, that the greatest contests for freedom "in this country, were, from the earliest times, chiefly "upon the question of taxing * * *. They took infinite "pains to inculcate, as a fundamental principle, that * * * "the people must, in effect, themselves, mediately or imme- "diately, possess the power of granting their own money, "or no shadow of Liberty could subsist. The Colonists "drew from you, as with their life blood, these ideas "and principles. Their love of Liberty, as with you, "was fixed and attached on this specific point of taxing."

These fundamental rights having been always admitted by the best thought of England, it may be con-

sidered a work of supererogation to cite further authorities to prove how ardently Americans concurred. However, a few American instances may be briefly quoted, to show the complete parallel of thought between the greatest English lovers of Liberty and the whole body of American freemen.

The Stamp Act Congress of 1765 declared: "That "his Majesty's liege subjects in these Colonies are en- "titled to all the **inherent** rights and **liberties** of his "natural born subjects within the Kingdom of Great "Britain. This is **inseparably essential to the freedom of "a people, and the undoubted right of Englishmen**—that **"no taxes be imposed upon them, but with their own con- "sent.** * * * That all supplies to the Crown, **being "free gifts from the people**, it is unreasonable and incon- "sistent with principles and spirit of the British Con- "stitution for the people of Great Britain to grant to "his Majesty **the property of the Colonists.**"

Of course, as Lord Chatham so accurately pointed out: "The idea of virtual representation of America "in this House, **is the most contemptible idea that ever en- "tered into the head of man.** It does not deserve a seri- "ous refutation."

So that we have the constantly recurring thought that mediate assent through representation must not be so fanciful that it interferes with the **consent** being real.

The greatest thinker among those dealing with these great questions,—Benjamin Franklin,—put this most clearly, when summoned before the British Parliament to explain the Colonists' viewpoint: "**Their "money ought not to be given away, without consent, by "persons at a distance, unacquainted with their circum- "stances and abilities.**" And he pointed out that this

right of **consent** was esteemed by the Colonists "**of the "utmost value and importance, as it is security for all their "other rights.**"

Americans having fought for and won these rights, formed a government in the blaze of light afforded by their complete knowledge of them gained from their own immediate experience.

So deeply, so solemnly, were they impressed, that they felt it vital that it be known that these rights were not only "unalienable," but the direct gift from God. Jefferson splendidly said: "Can the liberties of a na- "tion be thought secure, when we have removed their "only firm basis—a conviction in the minds of men **that "these liberties are the gifts of God**; that they are **not to "be violated but with His wrath?**" And the Declaration, that made us a free nation, with unanimous approval of all taking part, asserted an identical principle. One of the grounds that justified the dissolving of our ties with the Mother Country was, of course, that she had been guilty of "**imposing taxes on us without our consent**," a violation of the rights by which we were endowed by our Creator, "unalienable Rights" of "Life, Liberty, and the pursuit of Happiness," for the security of which Governments are instituted among men, from whose **consent** such Governments **alone** derive their just powers.

In this all disclosing light we must certainly find true guidance as to the meaning and vital purposes of Article I, Section 2, Clause 3, and Article I, Section 9, Clause 4, of the Constitution itself.

These provisions, indeed, stand on a parity with the provision assuring the independence of the Supreme Court (which also had been **unanimously** insisted upon), and have the peculiar distinction of having

been twice inserted into the Constitution—certainly a rare if not an unique thing; but a perfectly understandable thing to those who comprehend their true "genesis."

When one remembers what the Founders had just experienced, the liberality with which they granted consent to taxation is astounding. But there was one point where they would not yield,—where their actual experience had demonstrated the tyranny and oppression that was too sure to come, even where power of consent was held by their own kin and nationality, if those controlling such power were too distantly separated from them.

Blessed and happy, under the precautions the Fathers took to safeguard us, we have forgotten how they had suffered for want of such protection. We have lost both the learning and the knowledge which they had achieved through bitterest experiences. The Fathers, being great readers of Montesquieu, who, also, had pointed out the difficulty of a great Republic even continuing to exist at all, naturally feared what was the explanation proven by their own experience. Even Hamilton, though he felt a Republican Government was the only possibility, "expressed his despair of the practicability of establishing a Republican Government over so extensive a country as the United States."

But the solution found proved as simple as it was effective. Indirect taxation need not be feared, as had been proven by the failure of the British attempts, it being under the control of all citizens combining to abstain from the use of the taxed articles; but, which with a great and free people, would afford ample revenue not only to make the government rich, but dangerously rich, for enormous revenue is inevitably a temptation to

corruption, and dangerous and even despicable measures to obtain control of it. No free and great country had ever failed for want of revenue, though all are in danger from extravagance, waste and corruption.

But **direct taxation**, inflicted by men **too far distant** safely to be trusted with the vital power of **representative consent**, had long, not only been known, but proven to be a Republic's greatest danger. That the Constitution might be ordained, it was, therefore, imperative that this matter be completely safeguarded. The simplicity and effectiveness of the safeguarding provisions, in the Constitution, are most impressive. It was, therefore, ordained that, as there might possibly be emergencies requiring this power, that it should be granted, but only granted **conditionally**—(a practice, it will be remembered, that came into constant use under the reign of Henry III). That if the power were used, it could only be improperly used at the cost of penalizing every section **alike and equally**. And so our **internal** peace and happiness have continued. But have we not already new evidences, both in legislation and in the declarations of legislators, that like causes still have like effects, and that the apple of discord has once more been cast among us, though not yet bearing full effects because of the higher and paramount duty we all felt of submitting to anything necessary to preserve the freedom of the world through the recent crisis?

It cannot be doubted, therefore, that by following the suggestions of Mr. Justice Holmes in the Securities case, adopted, through Mr. Justice White, by the whole Court in the Standard Oil case, with the other guidance so clearly given by the Supreme Court, that we have reached the "**genesis**" of this matter that must profoundly affect the results which should finally be achieved?

No one has or will contend that the Supreme Court fell into error when it declared that: "Except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes" are not repealed or modified, as "**this "limitation has still an appropriate and important func-"tion, and is not to be overridden by Congress, or disre-"garded by the Courts.**" No one need doubt that this function was to prevent ultimate discord in our own country, that from the similar danger of **too distant power of consent**, had already rended in twain the British Empire.

We, thus, know the real "genesis" and high purpose, still subsisting, for which this provision was **twice** inserted in the Constitution; that it was to safeguard our Liberty against what all experience had demonstrated had always, theretofore, destroyed it; that is, the unlimited power of **consent** regarding direct taxation placed in the control of those **too distant** from us to insure fair and intelligent use.

And so the Sixteenth Amendment completely fails to establish the clarity of consent, necessary to let us continue freemen, except regarding but one phase of the matter, "**income**" alone. It not only does not grant but absolutely negatives any further power. We know how modern amendments to the Constitution have been made. We cannot possibly know how Congress and the Legislatures came to let down the bars in a matter that the Constitution still admittedly declares dangerous to American Liberty, as a general principle. The Amendment, or the discussion preceding it, gives us no clear light whatever upon the subject. Each of us may speculate upon that subject as he pleases. But we do know that the fundamental principle has only been

relaxed as to this single thing called "**Income.**" And thus we have a situation where, both positively and negatively, and from every point of view, whether we consider the subsisting principles of the Constitution or the Amendment itself, that can, alone, bring us to but a single result.

"Income" cannot by any possibility be stretched one iota beyond what "Income" has always clearly and generally been understood to be; if there be doubt, it must be construed in protection of the citizen; whilst, on the other hand, everything **directly** taxed must be strongly construed, to be within the protection of the principles originally introduced to protect our freedom, and as widely construed as is reasonably possible. Again, turning to the Common Law for our guidance in interpretation, we learn that it always **favors Liberty**. Even under the Tudors and Stuarts, it promulgated this fundamental and most important doctrine—"**In favour of Liberty.** * * * **Impius et crudelis** "**judicandus est, qui libertati non favet. Angliae jura in** "**omni casu libertati dant favorem.**" Coke on Littleton, 124 b. But the Constitution itself makes this doubly clear, fortifies it forever, goes even further, making it a chief purpose of that wonderful instrument—"We, "the people of the United States, **in order to** * * * "**secure the blessings of liberty to ourselves and our poster-**"**ity**, do ordain and establish this Constitution for the "United States of America." And every Judge of the United States, as well as of every separate State, "shall be bound by oath or affirmation to support this "Constitution." As Broom so well says: "If any doubt "arises from the terms employed by the Legislature, it "has always been held a safe means of collecting the "intention, the ground of making the statute, **and to**

"**have recourse to the preamble**, which, according to Chief "Justice Dyer, **is a key to open minds of the makers of** "**the Act**, and the mischiefs which they intended to "redress." The Preamble to the Constitution shows that the Fathers had in mind and intention the loss of the blessings of Liberty.

To those who love Liberty, can anything be finer? A splendid tribunal, without regard to the possible individual theories of those who may from time to time constitute it, nevertheless, as honorable men, bound to seek that interpretation of every word, every line, **that will safeguard our freedom**, and containing a clear definition of the most essential things for the preservation of our Liberty. With such guidance, where is the difficulty?

Although the matter may not have been so presented, the Supreme Court, by its own instinctive love of Liberty, certainly has guided us to safety.

In Gould vs. Gould, 245 U. S. 151, it has declared that: "In the interpretation of statutes levying taxes, "it is the established rule not to extend their provisions, "beyond the **clear** import of the language used, or **to** "**enlarge their operations** as to embrace matters not "specifically pointed out. **In case of doubt**, they are "construed most **strongly** against the government, and "in favor of the citizen." This certainly evidences clear comprehension of the principle involved, that as taxation without **consent** constitutes slavery, men are not to be guessed or "construed" into servitude, with the assent of that Court, which is, in fact, **the chief guardian of their Liberty**. And so, too, on like principle, the Common Law has **always** declared. It will be remembered it is our chief reliance on Constitutional inquiry.

Thus in the THORLEY CASE,[1] LORD LINDLEY says: "All "* * * taxing acts are to be read strictly; that is to "say, they are not to be extended so as to have the effect "of imposing on the subject a tax which Parliament "has not **clearly** made him pay. These principles are "perfectly familiar."

Again, Baron Pollock says in the CLIFFORD Case:[2] "It is stated in Maxwell on Statutes, 1st ed., page 259, "that 'Statutes which impose pecuniary burdens are "'subject to the rule of strict construction. It is a well-"'settled rule of law that all charges upon the subject "'must be imposed by **clear and unambiguous language**, "'**because in some degree they operate as penalties. The** "'**subject is not to be taxed unless the language by which** "'**the tax is imposed is perfectly clear and free from doubt.**' "For this proposition several decisions and dicta are "cited, and there is no doubt as to its being a correct "statement of the law. * * * If the statute is so indefi-"nite and uncertain that it can be treated in two ways, "and the true construction of it is open to two views, "the one more favorable to the Crown and the other to "the subject, then the latter construction should be "adopted."

Again, in the Beech Case,[3] Lord Justice SMITH, quoting from Lord Chancellor WENSLEYDALE, says: "It "is a well-established rule that the subject is not to be "taxed without clear words for that purpose. * * * "The Legislature by the circuitous route it has adopted "has obviously failed to carry out its object; but if this

[1] Thorley vs. Massam, L. R. 2 Ch. 613, at page 623 (1891).

[2] Clifford vs. Comm. of Inland Revenue, 2 Q. B. 187, at page 192 (1896).

[3] Attorney-General vs. Beech, 1898 A. C. 147, at page 150 (1898).

"be so, all I can say is, so much the worse for the Crown." Lord Justice CHITTY says:[4] "It is incumbent on the "Crown when claiming, the tax to make out affirma- "tively that the case falls within the statute. * * * "You must see that the tax is **expressly imposed**; the "subject is not to be taxed without **clear words**." And this judgment was affirmed by the House of Lords.[5]

And in the late EARL OF SELBOURNE Case,[6] it is pointed out that in taxation the Crown can never ask **"a benevolent intepretation"** for itself. See also the following cases in the House of Lords; Partington Case,[7] Cox vs. Rabit,[8] Pryce Case,[9] Oriental Bank Case.[10]

As the Government has been engaged in a continuing effort to impose taxes prohibited by the Constitution before the amendment, through what would simply be tax legislation by overruling both the judiciary and the Constitution, it may well be worth while to say a few words upon the essentially different principles and policies involved, and the radically different dangers and consequences that would arise from so amending the Constitution.

The Supreme Court of the United States has referred to the oft used comparison between a tree and its fruits, as an illustration of the difference between "Capital" and "Income." There is, therefore, propriety in adhering to it, and insisting upon the greatest clarity in maintaining this essential distinction.

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[4] *Id.*, at page 155.
[5] 1899 A. C. 56.
[6] 1902, I. K. B. 396.
[7] L. R. 4, H. of L., at page 22.
[8] 3 App. C. 478.
[9] 4 App. C. 203.
[10] 5 App. C. 856.

It is obvious that, prompted by patriotism, citizens might readily, and with due regard to their country's welfare yield, at the Legislature's discretion, a portion of the **income** or **fruits** annually accruing from their capital. But who can say, by mere surmise or guesswork, that they would think it either patriotic or for the welfare of their country that their orchards should be taken or destroyed in whole or in part by **consent** controlled by those **too far away**, particularly if they had grown more valuable through course of time, and were so yielding the larger and the more permanent fruits necessary for the continued supply and preservation of their country? Who is there that would not think that this was as unwise as the fathers thought it? A patriotic citizen, referring to a familiar fable, might well agree to share the golden eggs with his country,—nevertheless, he might not reach the supreme folly of, directly or indirectly, joining in an assassination of the goose that was laying them! And when he also knew that the values of everything had **in paper money** become dependent upon the mere will of far-distant communities that might not even know or care for his local situation or interests, would he not, even with but ordinary intelligence, be astounded by the proposition that these far-distant communities were to be given a power to insist upon that slaughter, however stupid?

Returning again to our illustration, let us give a distinguishing example of perfectly obvious results that must follow such folly.

As population increases and business succeeds, if the community is not to run into idleness and distress, **there must be a corresponding growth of capital to insure the necessary employment and industry to produce contentment and plenty.** It is, therefore, absolutely essential that

there should be an adequate increase of the amount and efficiency of the capital item requisite to additional employment and production. It is obvious that this may be increased from its own slow growth and accretion in the course of industry; and that for a higher degree of prosperity there must be even additional savings from available fruits or income. People have thus already learned how pernicious excess profit taxes are, and are unanimously seeking their abandonment. They have learned, through hard experience, that excess profits necessarily result from under-capitalization, in a given industry; and that they are not only God's cure, but the only available remedy, aided by economy and thrift, for the disease itself; that they are but another of the evils that have been imposed by accepting the absurd argument that **unwisdom** is ever "**necessary**." To tax excess profits is no wiser than it would be in a siege to draw troops for the reinforcement of a weak point, from still weaker points, or to stop circulation to the least nourished part of the body. But it is astounding, with all these conditions before our eyes, that even a far greater evil is actually being contended for; that the very life blood of the economic body of the community is to be sucked from it by a construction that will make capital, and its natural and slow variation through the years, subject to a still greater and more disastrous spoliation.

Again illustrating from what we actually see about us. Assuming that by Governmental edict, and the general forgetfulness that inflation always creates illusory estimates of value, it happens that a man having an orchard, or a farm, or mill, or invested capital of any kind, suddenly is led to believe that it has increased, through misleading inflation, perhaps, to three hundred

per cent. of the real value (which ultimately is sure to govern), and for any reason should desire or be forced to change his location or investment—an investment that he wishes to continue, not for enjoyment or taxes, but for the even more essential purpose of aiding that production essential to the very existence of the community. If the Government in such case could consider these gradual accretions **to be "Income"** and could tax them and the Capital on which they accrue under the pretense that they constituted "Income," must not an absolutely final exhaustion, not merely of the resources of the public, but of the Government itself, become inevitable? Taxation then might not merely be the power to destroy, **but be destruction itself**. Could anything be conceived of more completely illogical than such a governmental policy that must destroy that upon which the Government must live,—a very essential source of the income upon which it must exist.

A man has his orchard. Through long toilsome years it grows to the perfection of production; it has not only increased in real value, but this real value has apparently been multiplied by the unwise exercise of a governmental function of dishonestly depreciating the measure of value, not provided for in the Constitution. Compelled or wanting to change to another location or thing, what is asked but that, in doing so, he must sacrifice a part, the greater part, or perhaps the whole, of this effective capital to the Government, under a mere pretense that this essential requirement of all, in truth and fact, nothing but capital is but income; so that, on the reinvestment of what he has left, both he and the community discover that by legerdemain and a false use of words, not merely his **income**, but his

productive capital has been cut in half, or nearly destroyed. If that can be done, under the long established rule of judicial interpretation so far as taxing is concerned, and the specious arguments of "Necessity" are listened to, nothing further seems necessary so far as revenue is concerned; for, by mere interpretation, a single taxing act, to be subsequently construed by the rule that it is to be interpreted, not by what it **clearly** says, but by what the executive officers of the Government imagine they need, will fill all requirements—and Liberty end. Are Americans hereafter, instead of being ruled by the doctrines prevailing even in Great Britain, to face the fact that henceforth, where the Legislatures, with their full powers are not pleased to be explicit and clear, the rule is to be, not that vagueness is not to continue to be "**so much the worse for the Crown**," but so much the worse for the people and their constitutionally-protected freedom? Are we no longer to be taxed by the clear mandate of our proper representatives, but by a substitute of clearly distinguished and conflicting words, inserted by the executive branch of our Government? That must be impossible, if we are to remain free, and, as keeping us so is the great privilege of the Supreme Court we should have no further cause for anxiety concerning the destruction of constitutional guarantees through such abuses of the power of taxation.

There could be found no better illustration of the dangers and futility of the made or inferred argument of that "**creed of slaves-necessity**," than the very matter under discussion. The taxing power, disregarding the decisions of the Supreme Courts, not only of the United States, but of all the States, burdens the people by unwarranted taxes, on the theory that "**Income**," at

least, may be construed to be identical with the "**Capital**" from which it issues. If a false situation thus created can be used to change the fundamental meaning of the Constitution; if the Tax Collector can thus benefit by his own wrong, and place the unjust burdens of his errors upon the shoulders of people entitled to be free, there would seem to be little benefit in Constitutional protection at all. But that which it is now especially desired to make clear is the fallacy of such arguments, for nothing could be more preposterous than the pretense that a Government could, upon such an argument, be entitled to continue a practice that, if Liberty is to be preserved, and the Constitution protected, must be ended, and can be ended, at once, and without injury to any. For it must be borne in mind that the Government has the full Constitutional right to raise all its necessary revenue by the lawful exercise of the power of taxation. Not to return **to the same community** a sum taken unconstitutionally can in no sense be **a necessity**, when there continues the full power to take an equivalent amount justly and in accord with Constitutional right. And as we live under God's rule, it will always be found that these alleged "**necessities**" to do wrong are, as **John Milton** and **Lord Chatham** have pointed out in denouncing them, "**pleas of tyrants and creeds of slaves**" alone!

It is thus found that what we are dealing with is but an amendment **creating a power of further burdening an already heavily taxed people.** We have learned, however, from the Supreme Court how such statutes must be construed. And it has told us why. It cannot too often be said we were slaves, were a real **consent**, our real consent, not thus required. The vital thing is that we must not be enslaved by interpretation that admits

of doubt. The taxing power always has, if the people really approve, the full power of clear statement, and there is, therefore, no pretext for "paltering with us in a double sense" in so vital a matter. If the Government is not content plainly to ask specifically what **consent is desired**, that of iself is strongest reason to be on guard!

When we consider the matter from the viewpoint of the surviving Liberty that still abides with us in the unrepealed provisions of the original Constitution, the solution becomes overwhelmingly clear, for by History, Common Law and Constitution, they deeply involve our Liberty, and must be safeguarded against everything. We should thank our Creator that we have a Supreme Court that has never faltered in such cases.

As one may see by reading the decision in Towne vs. Eisner, 245 U. S. 418, the unanimous decision in Lynch vs. Turrish, 247 U. S. 221, and the very instructive discussion of the Justices in the Macomber case, which, though the point actually decided lies outside of the purpose of this work, the doctrines contended for in this Essay are, again, unanimously supported. The only real point actually involved, if the Macomber case be understood by the writer is whether or not the majority of the Court were right in considering, for example, that if a man had checked his hat and been given two checks for it, or had received duplicate bills of exchange for a single sum, or taken duplicate title deeds for his property, or been given, say, ten-twentieths, instead of five-twentieths of the same thing, he had really doubled it or not, for purposes of taxation. But there can be no question raised, since the unanimous decisions in the Gould, the Towne, and the Turrish cases. If they be but adhered to, and only considered so far as

the points actually **fully** discussed or decided therein (see as to possible dicta Cohens vs. Virginia, 6 Wheaton 399), they will afford proper solution in the fundamental principles really involved and fully considered.

For none can deny that before the "burdening" Amendment, free Americans possessed a **clear liberty** to use the results of their "pursuit of Happiness," at their free discretion, as "Capital" or "Income"; no one can deny that the slow accretions of Capital, as against equal possible wastage, could at their free discretion, and until they voluntarily severed it, still remain only Capital, and untaxable as such. Where, it may be asked, is our **clear consent**, that any taxing officer can destroy the **fundamental** liberty, by calling what the Supreme Court has maintained for half a century to be **Capital, and Capital only**;—what it never in all history has been, that is the entirely different thing called "**Income**"? Where, it is repeated, has our **consent** ever been granted, without which we would otherwise be reduced to servitude? Where is there the slightest evidence of assent to that? Is there the slightest doubt as to what the reply of the Fathers would be,—the real test?

The Supreme Court has more than once definitely ruled that the mere accretions to the Capital fund are but **increases of Capital, not Income at all** (Gray vs. Darlington, 15 Wall. 63; Lynch vs. Turrish, 247 U. S. 221, a very recent and unanimous decision; and see Towne vs. Eisner, 245 U. S. 418), the whole difficulty is described by Mr. Justice Holmes when, in his opinion in the Northern Securities case, 193 U. S., at page 403, he says: "Much trouble is made by substituting other "phrases **assumed to be equivalent, which then are rea-** "**soned from as if they were in the Act.**" And complete solution must result, if, in the present case, these words

having been already so completely defined, the Courts will, as Justice Holmes did but "**stick to the exact words used**," and not substitute for "Income," "Capital" or any part of that which has been repeatedly defined as "Capital" alone.

Therefore, to summarize: If the methods directed by the Supreme Court be followed, no one can deny that our Constitution provides for the safeguarding of our Liberty; that a condition of servitude is imposed on us, if the lawful results of our "pursuit of Happiness" could be taken from us withou full **consent really and freely given**; that so far as **direct** taxes are concerned, such **consent**, generally, not only cannot be given for the people of any single State, **by those distant**, unless apportioned as provided in the Constitution, but is absolutely denied, as a necessary protection of Liberty from what had already so destroyed it, as to require a fratricidal war to regain it; that this was the solemn conclusion of the greatest, most patriotic, body of statesmen ever assembled; that the general principle remains inviolate, though, for unknowable reason, power to subject us to this danger to our Liberty, is and has been granted but only in one respect, that is as to "**Income**," but, again, "**Income**" alone! That this provision is "burdening," not remedial—for he would have not only courage, but a grim sense of humor, who could contend, especially in these times, that further powers to burden the people, had for the first time become "remediable" legislation. That "**Income**" had not only never been defined as Capital or Capital accretions, in continued use as Capital, but by more than one decision, and during a period exceeding half a century, continuously and clearly declared by the Supreme Court, not to include either! And that the only reply

is that the taxing power, nevertheless, did not approve of the superiority of the Constitution; and its interpretation by the Supreme Court; so that the matter has really reduced itself to what and who is the controlling and final authority in matters relating to the very vitals of Liberty under the Constituion. It can safely be left there.

There has been but one instance in which the methods thus applied, have been departed from, but with such evil results, and results that would so enormously enhance the evils of a second departure, that a second chapter in relation to it may be of advantage.

CHAPTER II.

THE COST OF IGNORING THE METHODS OF CONSTITUTIONAL INTERPRETATION AS PRESCRIBED BY THE SUPREME COURT.

*"Constitutional provisions for the security of person "and property should be liberally construed. * * * "It is the duty of Courts to be watchful for the con- "stitutional rights of the citizen, and against any "stealthy encroachments thereon."*

—Monongahela Navigation Co. vs. United States, 148 U. S. 325.

Article I, Section 8, Clause 5 of the Constitution provides that Congress shall have power "**to coin money.**" Clause 6: "To provide for the punishment of counter- "feiting the securities and **coin** of the United States." It, therefore, expressly provides for the money that Congress is to have the power to make, as well the kind of money that Congress is to have the power of punishing the counterfeiting thereof. It does not leave this power open to implication. The power is definitely defined. The claim that the words "**and also issue paper money**" should be added, would seem to be disposed of by mere reference to the established maxim "**expressum facet cessare tacitum**"; for "if authority is given expressly, "though by affirmative words, upon a defined condi- "tion, the expression of that condition, excludes the "doing of the act authorized under other circumstances "than those defined, '**expressio unius est exclusio alteri- "us**'." Willes, J., North Stafford case, L. R. 3, Ex. 177.

But were there doubt, it was the duty of the Court, as already explained, to solve it, by inquiry as to the

history of the matter, and what must have been the meaning at the time of those who ordained the Constitution.

No one thoroughly searching this out could have been left with a possibility of doubt. If there was anything from which they had suffered, it was a paper currency, whose value had so depreciated that it had come to symbolize extreme and contemptible worthlessness! There was nothing that they thought more "iniquitous," more "ruinous," more "fraudulent," more "poisonous of the community," more "to establish iniquity by law." That they so regarded paper currency is beyond possible doubt.

It so happened that there existed in the smallest State of the Union, Rhode Island, a faction of anti-Federalists in favor of continuing the power of issuing paper money and passing Tender Acts. They not only seemed to have stood alone, but their answer was left to one of the greatest of the founders of our Government, a man that President Washington so approved that he subsequently made him the Chief Justice of the United States, with the consent and approval of the Senate. Oliver Ellsworth was not only a patriot, but a great lawyer, and no man can believe, who reads his splendid treatment of this subject, that the founders of our Government, by any possibility, could have dreamt that they were creating an implied power to do that which they believed was both dangerous and infamous. In his scathing address of March 17, 1788, "To the Rhode Island Friends of Paper Money, Tender Acts and Anti-Federalism," he says:[11] "The singular sys-

[11] "Federal Statesmen Series" (Albert Scott & Co., Chicago 1894), Vol. II, page 600.

"tem of policy adopted by your State, no longer excites "either the surprise or indignation of mankind. There "are certain extremes of iniquity, which are beheld "with patience, from a fixed conviction that the trans- "gressor is inveterate, and that his example from its "great injustice hath no longer a seducing influence. "* * * Experiments in public credit, though ruin- "ous to thousands, and a disregard to the promise of "government had been pardoned in the moment of ex- "treme necessity, and many honest men did not realize "that a repetition of them in an hour less critical would "shake the existence of society. Men full of evil and "desperate fortune were ready to propose every method "of public fraud that can be effected by a violation of "public faith and depreciating promises. This poison "of the community was their only preservation from "deferred poverty, and from prisons appointed to be the "reward for indolence and knavery. An easement of "the poor and necessitous was plead as a reason for "measures which have reduced them to more extreme "necessity. Most of the States * * * have made "their experiments in a false policy; but it was done "with a timorous mind, and seeing the evil they have "receded. A sense of subordination and moral right "was their check. Most of the people were convinced, "and but few remained who wished to establish iniquity "by law. To silence such opposition as might be made "to the new Constitution, it was fit that public injustice "should be exhibited in its greatest degree and most "extreme effects. For this end Heaven permitted your "apostacy from all the principles of good and just gov- "ernment. By your system we see unrighteousness in "the essence, in effects, and in its native miseries. The "rogues of every other State blush at the exhibition.

"* * * The very naming of your measures is a com-
"plete refutation of anti-Federalism, paper money and
"tender acts, for no man chooses such company in argu-
"ment. The distress to which many of your best citi-
"zens are reduced * * * of widows and orphans,
"demonstrates that unhappiness follows vice by the un-
"alterable laws of nature and society. * * * The
"whole Union has seen and fears, and while history
"gives true information, no other people will ever re-
"peat the studied process of fraud."

It was upon this argument that in the next year the Constitution was adopted, and this prediction held true through all the difficulties of our subsequent wars and throughout the following generations until the Supreme Court reversed itself in the later Legal Tender decisions, which were obtained in the manner familiar to all, opening forever a perfect Pandora's box of dangerous and unceasing evils to our country; and not the least of these, to the Supreme Court of the United States itself, the supreme and most important invention of the Constitution. For upon it must continuously fall the task of passing upon the unjust attempts of classes to impose unfair burdens.

However that may be, and however serious the burdens that ourselves and our posterity must ever struggle with, however the backs of toilers may stagger under them, the present interest is confined to the fact that we must hereafter consider further proposed encroachments upon the Constitution with the knowledge of the existing factor that it is, until the later Legal Tender decision may happily be departed from, still within established governmental power to play a game of battledoor and shuttlecock with the values of all commodities by legislation creating a depreciating cur-

rency; and, thus, try to realize the consequences of an added similar departure from the methods of interpretation so often designated by the Supreme Court.

The Supreme Court, of course, remained true to its principles. The real responsibility was on the legislative and executive branches of the Government, not on the Judiciary, for the overthrow of the first decision rendered in the legal tender cases. The method by which the later decision was secured is well known to all students of constitutional law and history.

For if ever a Pandora's box of evils was let loose upon the country, it was in this unhappy instance.

Forever now, political pressure will be brought upon the Congress, to advance prices by depreciating the currency; forever will conflict continue between those wanting indirect relief from debt, and those wanting honest payment; forever must the commercial interests of the nation be liable to be suddenly converted into the wildest gamble, with the certain results of either ruin, or disturbing charges of alleged "profiteering"; forever must our wars cost us at least double; forever must the Supreme Court be burdened with an irritating and dangerous conflict, dangerous to it and to all! A greater part of the present commercial distress is due to this evil, which the Founders strove so hard to guard us against.

The Supreme Court has well instructed us: That this question as well as all others "which run along "the line of the extent of the protection the individual "has under the Constitution against the demands of "the Government is of importance; for in any society "the fullness and sufficiency of the securities which sur-"round the individual in the use and enjoyment of his "property constitute one of the most certain tests of

"the character and value of the government." Monongahela case, 148 U. S., page 324. So that we are compelled to face the real danger confronting us, and ascertain whether we are to remain a free Republic or become a Bolshevist despotism? For, obviously, the real distinction between them lies in the fact that, in the first case what men properly gain from their unalienable pursuit of happiness **is theirs**. Whilst in the latter it is subject to the control of those who have not created it. That: "**Indeed, in a free government, all other "rights would become worthless, if the Government pos-"sessed an uncontrolled power over the private fortunes of "every citizen.**" Chicago, &c. case, 166 U. S. 235. That: "**Life, Liberty, and Property, and the equal protection of "the law**, grouped together in the Constitution, **are so re-"lated** that the depreciation of any one of these separate "and independent rights **may lessen or extinguish the "value of the other three.**" Loan Association Case, 20 Wall. 663; Smith ys. Texas, 233 U. S. 636. That: "You take my life when you do take the means whereby I live." Adams Case, 244 U. S. 593.

But such taking, by majority order, is the very heart of the Russian polity; the prohibition of it, that of Free America. So it follows that we now have the inevitable official report that Russia has become a veritable "vacuum of goods." The knowledge that by not enslaving men, we are still, after all our trials, the richest, best supplied nation the world has ever known, to which all other countries are looking for aid, through the kindly principles of freedom, the inevitable results of merely safeguarding men in their enjoyment of what their labors have produced, and consequently and fairly is their own. In other words, that enslaving men is always economic error. But—"By their fruits ye shall know them!"

WALSH, COLLECTOR OF INTERNAL REVENUE, *v.* BREWSTER.

ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE DISTRICT OF CONNECTICUT.

No. 742. Argued March 10, 11, 1921.—Decided March 28, 1921.

1. Bonds bought as an investment in 1909 were sold in 1916 for the amount originally paid, which was more, however, than their market value on March 1, 1913. *Held*, that there was no taxable income. P. 537. *Goodrich* v. *Edwards*, *ante*, 527.
2. Bonds bought in 1902–1903 were sold in 1916 at an increase over the investment price and at a still larger increase over their market value on March 1, 1913. *Held*, that the gain over the investment was the income taxable. P. 538. *Goodrich* v. *Edwards*, *ante*, 527.
3. Interest should not be added to the original investment in computing the amount of gain—income—upon a sale. P. 538.
4. A stock dividend *held* not income of the stockholder. P. 538. *Eisner* v. *Macomber*, 252 U. S. 189.

268 Fed. Rep. 207, reversed in part and affirmed in part.

THE case is stated in the opinion.

The Solicitor General for plaintiff in error.

Mr. William D. Guthrie and *Mr. Henry F. Parmelee*, with whom *Mr. George D. Watrous* and *Mr. Barry Mohun* were on the brief, for defendant in error.

Mr. H. Edgar Barnes, by leave of court, filed a brief as *amicus curiæ*.

MR. JUSTICE CLARKE delivered the opinion of the court.

In this case the defendant in error sued the plaintiff in error, a collector of Internal Revenue, to recover income taxes for the year 1916, assessed in 1918, and which were paid under protest to avoid penalties. The defendant answered, the case was tried upon an agreed statement of facts, and judgment was rendered in favor of the taxpayer, the defendant in error. The case is properly here by writ of error. *Towne* v. *Eisner*, 245 U. S. 418.

The defendant in error was not a trader or dealer in stocks or bonds, but occasionally purchased and sold one or the other for the purpose of changing his investments.

Three transactions are involved.

The first relates to bonds of the International Navigation Company, purchased in 1899, for $191,000, and sold in 1916 for the same amount. The market value of these bonds on March 1, 1913, was $151,845, and the tax in dispute was assessed on the difference between this amount and the amount for which they were sold in 1916, viz, $39,155.

The trial court held that this apparent gain was capital assets and not taxable income under the Sixteenth Amendment to the Constitution of the United States, and rendered judgment in favor of the defendant in error for the amount of the tax which he had paid.

The ground upon which this part of the judgment was justified below is held to be erroneous in No. 608, *Merchants' Loan & Trust Co.* v. *Smietanka*, this day decided, *ante*, 509, but, since the owner of the stock did not realize any gain on his original investment by the sale in 1916, the judgment was right in this respect, and under authority of the opinion and judgment in No. 663, *Goodrich* v. *Ed-*

wards, also rendered this day, *ante*, 527, this part of the judgment is affirmed.

The second transaction involved the purchase in 1902 and 1903 of bonds of the International Mercantile Marine Company for $231,300, which were sold in 1916 for $276,150. This purchase was made through an underwriting agreement such that the purchaser did not receive any interest upon the amount paid prior to the allotment to him of the bonds in 1906, and he claimed that interest upon the investment for the time which so elapsed should be added as a part of the cost to him of the bonds. But this claim was properly rejected by the trial court under authority of *Hays* v. *Gauley Mountain Coal Co.*, 247 U. S. 189.

It is stipulated that the market value of these bonds on March 1, 1913, was $164,480, and the collector assessed the tax upon the difference between the selling price and this amount, but since the gain to the taxpayer was only the difference between his investment of $231,300 and the amount realized by the sale, $276,150, under authority of No. 663, *Goodrich* v. *Edwards*, this day decided, he was taxable only on $44,850.

The District Court, however, held that any gain realized by the sale was a mere conversion of capital assets and was not income which could lawfully be taxed. In this respect the court fell into error. The tax was properly assessed, but only upon the difference between the purchase and selling price of the bonds as stated.

The third transaction related to stock in the Standard Oil Company of California, received through the same stock dividend involved in *Eisner* v. *Macomber*, 252 U. S. 189. The District Court, upon authority of that case, properly held that the assessment made and collected upon this dividend should be refunded to the defendant in error.

It results that as to the profit realized upon the second transaction, as indicated in this opinion, the judgment of the District Court is reversed, but as to the other transac-

tions it is affirmed for the reasons and upon the grounds herein stated.

Judgment reversed in part, affirmed in part, and case remanded.

MR. JUSTICE HOLMES and MR. JUSTICE BRANDEIS, because of prior decisions of the court, concur only in the judgment.